

Chairman's Letter - 1987

 berkshirehathaway.com/letters/1987.html

BERKSHIRE HATHAWAY INC.

To the Shareholders of Berkshire Hathaway Inc.:

Our gain in net worth during 1987 was \$464 million, or 19.5%. Over the last 23 years (that is, since present management took over), our per-share book value has grown from \$19.46 to \$2,477.47, or at a rate of 23.1% compounded annually.

What counts, of course, is the rate of gain in per-share business value, not book value. In many cases, a corporation's book value and business value are almost totally unrelated. For example, just before they went bankrupt, LTV and Baldwin-United published yearend audits showing their book values to be \$652 million and \$397 million, respectively. Conversely, Belridge Oil was sold to Shell in 1979 for \$3.6 billion although its book value was only \$177 million.

At Berkshire, however, the two valuations have tracked rather closely, with the growth rate in business value over the last decade moderately outpacing the growth rate in book value. This good news continued in 1987.

Our premium of business value to book value has widened for two simple reasons: We own some remarkable businesses and they are run by even more remarkable managers.

You have a right to question that second assertion. After all, CEOs seldom tell their shareholders that they have assembled a bunch of turkeys to run things. Their reluctance to do so makes for some strange annual reports. Oftentimes, in his shareholders' letter, a CEO will go on for pages detailing corporate performance that is woefully inadequate. He will nonetheless end with a warm paragraph describing his managerial comrades as "our most precious asset." Such comments sometimes make you wonder what the other assets can possibly be.

At Berkshire, however, my appraisal of our operating managers is, if anything, understated. To understand why, first take a look at page 7, where we show the earnings (on an historical-cost accounting basis) of our seven largest non-financial units: Buffalo News, Fechheimer, Kirby, Nebraska Furniture Mart, Scott Fetzer Manufacturing Group, See's Candies, and World Book. In 1987, these seven business units had combined operating earnings before interest and taxes of \$180 million.

By itself, this figure says nothing about economic performance. To evaluate that, we must know how much total capital - debt and equity - was needed to produce these earnings.

Debt plays an insignificant role at our seven units: Their net interest expense in 1987 was only \$2 million. Thus, pre-tax earnings on the equity capital employed by these businesses amounted to \$178 million. And this equity - again on an historical-cost basis - was only \$175 million.

If these seven business units had operated as a single company, their 1987 *after-tax* earnings would have been approximately \$100 million - a return of about 57% on equity capital. You'll seldom see such a percentage anywhere, let alone at large, diversified companies with nominal leverage. Here's a benchmark: In its 1988 Investor's Guide issue, Fortune reported that among the 500 largest industrial companies and 500 largest service companies, only six had averaged a return on equity of over 30% during the previous decade. The best performer among the 1000 was Commerce Clearing House at 40.2%.

Of course, the returns that Berkshire earns from these seven units are not as high as their underlying returns because, in aggregate, we bought the businesses at a substantial premium to underlying equity capital. Overall, these operations are carried on our books at about \$222 million above the historical accounting values of the underlying assets. However, the managers of the units should be judged by the returns they achieve on the underlying assets; what we pay for a business does not affect the amount of capital its manager has to work with. (If, to become a shareholder and part owner of Commerce Clearing House, you pay, say, six times book value, that does not change CCH's return on equity.)

Three important inferences can be drawn from the figures I have cited. First, the current business value of these seven units is far above their historical book value and also far above the value at which they are carried on Berkshire's balance sheet. Second, because so little capital is required to run these businesses, they can grow while concurrently making almost all of their earnings available for deployment in new opportunities. Third, these businesses are run by truly extraordinary managers. The Blumkins, the Heldmans, Chuck Huggins, Stan Lipsey, and Ralph Schey all meld unusual talent, energy and character to achieve exceptional financial results.

For good reasons, we had very high expectations when we joined with these managers. In every case, however, our experience has greatly exceeded those expectations. We have received far more than we deserve, but we are willing to accept such inequities. (We subscribe to the view Jack Benny expressed upon receiving an acting award: "I don't deserve this, but then, I have arthritis and I don't deserve that either.")

Beyond the Sainted Seven, we have our other major unit, insurance, which I believe also has a business value well above the net assets employed in it. However, appraising the business value of a property-casualty insurance company is a decidedly

imprecise process. The industry is volatile, reported earnings oftentimes are seriously inaccurate, and recent changes in the Tax Code will severely hurt future profitability. Despite these problems, we like the business and it will almost certainly remain our largest operation. Under Mike Goldberg's management, the insurance business should treat us well over time.

With managers like ours, my partner, Charlie Munger, and I have little to do with operations. In fact, it is probably fair to say that if we did more, less would be accomplished. We have no corporate meetings, no corporate budgets, and no performance reviews (though our managers, of course, oftentimes find such procedures useful at their operating units). After all, what can we tell the Blumkins about home furnishings, or the Heldmans about uniforms?

Our major contribution to the operations of our subsidiaries is applause. But it is not the indiscriminate applause of a Pollyanna. Rather it is informed applause based upon the two long careers we have spent intensively observing business performance and managerial behavior. Charlie and I have seen so much of the ordinary in business that we can truly appreciate a virtuoso performance. Only one response to the 1987 performance of our operating managers is appropriate: sustained, deafening applause.

Sources of Reported Earnings

The table on the following page shows the major sources of Berkshire's reported earnings. In the table, amortization of Goodwill and other major purchase-price accounting adjustments are not charged against the specific businesses to which they apply but, instead, are aggregated and shown separately. In effect, this procedure presents the earnings of our businesses as they would have been reported had we not purchased them. In appendixes to my letters in the 1983 and 1986 annual reports, I explained why this form of presentation seems to us to be more useful to investors and managers than the standard GAAP presentation, which makes purchase-price adjustments on a business-by-business basis. The total net earnings we show in the table are, of course, identical to the GAAP figures in our audited financial statements.

In the Business Segment Data on pages 36-38 and in the Management's Discussion section on pages 40-44 you will find much additional information about our businesses. In these sections you will also find our segment earnings reported on a GAAP basis. I urge you to read that material, as well as Charlie Munger's letter to Wesco shareholders, describing the various businesses of that subsidiary, which starts on page 45.

(000s omitted)

Berkshire's Share

of Net Earnings
(after taxes and
Pre-Tax Earnings minority interests)

	1987	1986	1987	1986
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Operating Earnings:

Insurance Group:

Underwriting	\$(55,429)	\$(55,844)	\$(20,696)	\$(29,864)
Net Investment Income	152,483	107,143	136,658	96,440
Buffalo News	39,410	34,736	21,304	16,918
Fechheimer (Acquired 6/3/86)	13,332	8,400	6,580	3,792
Kirby	22,408	20,218	12,891	10,508
Nebraska Furniture Mart	16,837	17,685	7,554	7,192
Scott Fetzer Mfg. Group	30,591	25,358	17,555	13,354
See's Candies	31,693	30,347	17,363	15,176
Wesco - other than Insurance	6,209	5,542	4,978	5,550
World Book	25,745	21,978	15,136	11,670
Amortization of Goodwill	(2,862)	(2,555)	(2,862)	(2,555)

Other Purchase-Price

Accounting Adjustments	(5,546)	(10,033)	(6,544)	(11,031)
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Interest on Debt and

Pre-Payment Penalty	(11,474)	(23,891)	(5,905)	(12,213)
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Shareholder-Designated

Contributions	(4,938)	(3,997)	(2,963)	(2,158)
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Other	22,460	20,770	13,696	8,685
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Operating Earnings	280,919	195,857	214,745	131,464
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Sales of Securities	27,319	216,242	19,807	150,897
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Total Earnings - All Entities ..	\$308,238	\$412,099	\$234,552	\$282,361
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Gypsy Rose Lee announced on one of her later birthdays: "I have everything I had last year; it's just that it's all two inches lower." As the table shows, during 1987 almost all of our businesses aged in a more upbeat way.

There's not a lot new to report about these businesses - and that's good, not bad. Severe change and exceptional returns usually don't mix. Most investors, of course, behave as if just the opposite were true. That is, they usually confer the highest price-earnings ratios on exotic-sounding businesses that hold out the promise of feverish change. That prospect lets investors fantasize about future profitability rather than face today's business realities. For such investor-dreamers, any blind date is preferable to one with the girl next door, no matter how desirable she may be.

Experience, however, indicates that the best business returns are usually achieved by companies that are doing something quite similar today to what they were doing five or ten years ago. That is no argument for managerial complacency. Businesses always have opportunities to improve service, product

lines, manufacturing techniques, and the like, and obviously these opportunities should be seized. But a business that constantly encounters major change also encounters many chances for major error. Furthermore, economic terrain that is forever shifting violently is ground on which it is difficult to build a fortress-like business franchise. Such a franchise is usually the key to sustained high returns.

The Fortune study I mentioned earlier supports our view. Only 25 of the 1,000 companies met two tests of economic excellence - an average return on equity of over 20% in the ten years, 1977 through 1986, and no year worse than 15%. These business superstars were also stock market superstars: During the decade, 24 of the 25 outperformed the S&P 500.

The Fortune champs may surprise you in two respects. First, most use very little leverage compared to their interest-paying capacity. Really good businesses usually don't need to borrow. Second, except for one company that is "high-tech" and several others that manufacture ethical drugs, the companies are in businesses that, on balance, seem rather mundane. Most sell non-sexy products or services in much the same manner as they did ten years ago (though in larger quantities now, or at higher prices, or both). The record of these 25 companies confirms that making the most of an already strong business franchise, or concentrating on a single winning business theme, is what usually produces exceptional economics.

Berkshire's experience has been similar. Our managers have produced extraordinary results by doing rather ordinary things - but doing them exceptionally well. Our managers protect their franchises, they control costs, they search for new products and markets that build on their existing strengths and they don't get diverted. They work exceptionally hard at the details of their businesses, and it shows.

Here's an update:

- Agatha Christie, whose husband was an archaeologist, said that was the perfect profession for one's spouse: "The older you become, the more interested they are in you." It is students of business management, not archaeologists, who should be interested in Mrs. B (Rose Blumkin), the 94-year-old chairman of Nebraska Furniture Mart.

Fifty years ago Mrs. B started the business with \$500, and today NFM is far and away the largest home furnishings store in the country. Mrs. B continues to work seven days a week at the job from the opening of each business day until the close. She buys, she sells, she manages - and she runs rings around the competition. It's clear to me that she's gathering speed and may well reach her full potential in another five or ten years. Therefore, I've persuaded the Board to scrap our mandatory retirement-at-100 policy. (And it's about time: With every

passing year, this policy has seemed sillier to me.)

Net sales of NFM were \$142.6 million in 1987, up 8% from 1986. There's nothing like this store in the country, and there's nothing like the family Mrs. B has produced to carry on: Her son Louie, and his three boys, Ron, Irv and Steve, possess the business instincts, integrity and drive of Mrs. B. They work as a team and, strong as each is individually, the whole is far greater than the sum of the parts.

The superb job done by the Blumkins benefits us as owners, but even more dramatically benefits NFM's customers. They saved about \$30 million in 1987 by buying from NFM. In other words, the goods they bought would have cost that much more if purchased elsewhere.

You'll enjoy an anonymous letter I received last August:
"Sorry to see Berkshire profits fall in the second quarter. One way you may gain back part of your lost. (sic) Check the pricing at The Furniture Mart. You will find that they are leaving 10% to 20% on the table. This additional profit on \$140 million of sells (sic) is \$28 million. Not small change in anyone's pocket! Check out other furniture, carpet, appliance and T.V. dealers. Your raising prices to a reasonable profit will help. Thank you.
/signed/ A Competitor."

NFM will continue to grow and prosper by following Mrs. B's maxim: "Sell cheap and tell the truth."

- Among dominant papers of its size or larger, the Buffalo News continues to be the national leader in two important ways: (1) its weekday and Sunday penetration rate (the percentage of households in the paper's primary market area that purchase it); and (2) its "news-hole" percentage (the portion of the paper devoted to news).

It may not be coincidence that one newspaper leads in both categories: an exceptionally "newsrich" product makes for broad audience appeal, which in turn leads to high penetration. Of course, quantity must be matched by quality. This not only means good reporting and good writing; it means freshness and relevance. To be indispensable, a paper must promptly tell its readers many things they want to know but won't otherwise learn until much later, if ever.

At the News, we put out seven fresh editions every 24 hours, each one extensively changed in content. Here's a small example that may surprise you: We redo the obituary page in every edition of the News, or seven times a day. Any obituary added runs through the next six editions until the publishing cycle has been completed.

It's vital, of course, for a newspaper to cover national and international news well and in depth. But it is also vital for

it to do what only a local newspaper can: promptly and extensively chronicle the personally-important, otherwise-unreported details of community life. Doing this job well requires a very broad range of news - and that means lots of space, intelligently used.

Our news hole was about 50% in 1987, just as it has been year after year. If we were to cut it to a more typical 40%, we would save approximately \$4 million annually in newsprint costs. That interests us not at all - and it won't interest us even if, for one reason or another, our profit margins should significantly shrink.

Charlie and I do not believe in flexible operating budgets, as in "Non-direct expenses can be X if revenues are Y, but must be reduced if revenues are Y - 5%." Should we really cut our news hole at the Buffalo News, or the quality of product and service at See's, simply because profits are down during a given year or quarter? Or, conversely, should we add a staff economist, a corporate strategist, an institutional advertising campaign or something else that does Berkshire no good simply because the money currently is rolling in?

That makes no sense to us. We neither understand the adding of unneeded people or activities because profits are booming, nor the cutting of essential people or activities because profitability is shrinking. That kind of yo-yo approach is neither business-like nor humane. Our goal is to do what makes sense for Berkshire's customers and employees at all times, and never to add the unneeded. ("But what about the corporate jet?" you rudely ask. Well, occasionally a man must rise above principle.)

Although the News' revenues have grown only moderately since 1984, superb management by Stan Lipsey, its publisher, has produced excellent profit growth. For several years, I have incorrectly predicted that profit margins at the News would fall. This year I will not let you down: Margins will, without question, shrink in 1988 and profit may fall as well. Skyrocketing newsprint costs will be the major cause.

● Fechheimer Bros. Company is another of our family businesses - and, like the Blumkins, what a family. Three generations of Heldmans have for decades consistently, built the sales and profits of this manufacturer and distributor of uniforms. In the year that Berkshire acquired its controlling interest in Fechheimer - 1986 - profits were a record. The Heldmans didn't slow down after that. Last year earnings increased substantially and the outlook is good for 1988.

There's nothing magic about the Uniform business; the only magic is in the Heldmans. Bob, George, Gary, Roger and Fred know the business inside and out, and they have fun running it. We are fortunate to be in partnership with them.

- Chuck Huggins continues to set new records at See's, just as he has ever since we put him in charge on the day of our purchase some 16 years ago. In 1987, volume hit a new high at slightly Under 25 million pounds. For the second year in a row, moreover, same-store sales, measured in pounds, were virtually unchanged. In case you are wondering, that represents improvement: In each of the previous six years, same-store sales had fallen.

Although we had a particularly strong 1986 Christmas season, we racked up better store-for-store comparisons in the 1987 Christmas season than at any other time of the year. Thus, the seasonal factor at See's becomes even more extreme. In 1987, about 85% of our profit was earned during December.

Candy stores are fun to visit, but most have not been fun for their owners. From what we can learn, practically no one besides See's has made significant profits in recent years from the operation of candy shops. Clearly, Chuck's record at See's is not due to a rising industry tide. Rather, it is a one-of-a-kind performance.

His achievement requires an excellent product - which we have - but it also requires genuine affection for the customer. Chuck is 100% customer-oriented, and his attitude sets the tone for the rest of the See's organization.

Here's an example of Chuck in action: At See's we regularly add new pieces of candy to our mix and also cull a few to keep our product line at about 100 varieties. Last spring we selected 14 items for elimination. Two, it turned out, were badly missed by our customers, who wasted no time in letting us know what they thought of our judgment: "A pox on all in See's who participated in the abominable decision...;" "May your new truffles melt in transit, may they sour in people's mouths, may your costs go up and your profits go down...;" "We are investigating the possibility of obtaining a mandatory injunction requiring you to supply...;" You get the picture. In all, we received many hundreds of letters.

Chuck not only reintroduced the pieces, he turned this miscue into an opportunity. Each person who had written got a complete and honest explanation in return. Said Chuck's letter: "Fortunately, when I make poor decisions, good things often happen as a result...;" And with the letter went a special gift certificate.

See's increased prices only slightly in the last two years. In 1988 we have raised prices somewhat more, though still moderately. To date, sales have been weak and it may be difficult for See's to improve its earnings this year.

- World Book, Kirby, and the Scott Fetzer Manufacturing Group are all under the management of Ralph Schey. And what a lucky

thing for us that they are. I told you last year that Scott Fetzer performance in 1986 had far exceeded the expectations that Charlie and I had at the time of our purchase. Results in 1987 were even better. Pre-tax earnings rose 10% while average capital employed declined significantly.

Ralph's mastery of the 19 businesses for which he is responsible is truly amazing, and he has also attracted some outstanding managers to run them. We would love to find a few additional units that could be put under Ralph's wing.

The businesses of Scott Fetzer are too numerous to describe in detail. Let's just update you on one of our favorites: At the end of 1987, World Book introduced its most dramatically-revised edition since 1962. The number of color photos was increased from 14,000 to 24,000; over 6,000 articles were revised; 840 new contributors were added. Charlie and I recommend this product to you and your family, as we do World Book's products for younger children, Childcraft and Early World of Learning.

In 1987, World Book unit sales in the United States increased for the fifth consecutive year. International sales and profits also grew substantially. The outlook is good for Scott Fetzer operations in aggregate, and for World Book in particular.

Insurance Operations

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

	<i>Statutory</i>			
	<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>
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1981	3.8	106.0	6.5	9.6
1982	4.4	109.8	8.4	6.4
1983	4.6	112.0	6.8	3.8
1984	9.2	117.9	16.9	3.7
1985	22.1	116.3	16.1	3.2
1986 (Rev.)	22.2	108.0	13.5	2.6
1987 (Est.)	8.7	104.7	6.8	3.0

Source: Best's Insurance Management Reports

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. When the investment income that an insurer earns from holding on to policyholders' funds ("the float") is taken into account, a combined ratio in the 107-111 range typically produces an overall break-even result, exclusive of

earnings on the funds provided by shareholders.

The math of the insurance business, encapsulated by the table, is not very complicated. In years when the industry's annual gain in revenues (premiums) pokes along at 4% or 5%, underwriting losses are sure to mount. That is not because auto accidents, fires, windstorms and the like are occurring more frequently, nor has it lately been the fault of general inflation. Today, social and judicial inflation are the major culprits; the cost of entering a courtroom has simply ballooned. Part of the jump in cost arises from skyrocketing verdicts, and part from the tendency of judges and juries to expand the coverage of insurance policies beyond that contemplated by the insurer when the policies were written. Seeing no let-up in either trend, we continue to believe that the industry's revenues must grow at about 10% annually for it to just hold its own in terms of profitability, even though general inflation may be running at a considerably lower rate.

The strong revenue gains of 1985-87 almost guaranteed the industry an excellent underwriting performance in 1987 and, indeed, it was a banner year. But the news soured as the quarters rolled by: Best's estimates that year-over-year volume increases were 12.9%, 11.1%, 5.7%, and 5.6%. In 1988, the revenue gain is certain to be far below our 10% "equilibrium" figure. Clearly, the party is over.

However, earnings will not immediately sink. A lag factor exists in this industry: Because most policies are written for a one-year term, higher or lower insurance prices do not have their full impact on earnings until many months after they go into effect. Thus, to resume our metaphor, when the party ends and the bar is closed, you are allowed to finish your drink. If results are not hurt by a major natural catastrophe, we predict a small climb for the industry's combined ratio in 1988, followed by several years of larger increases.

The insurance industry is cursed with a set of dismal economic characteristics that make for a poor long-term outlook: hundreds of competitors, ease of entry, and a product that cannot be differentiated in any meaningful way. In such a commodity-like business, only a very low-cost operator or someone operating in a protected, and usually small, niche can sustain high profitability levels.

When shortages exist, however, even commodity businesses flourish. The insurance industry enjoyed that kind of climate for a while but it is now gone. One of the ironies of capitalism is that most managers in commodity industries abhor shortage conditions - even though those are the only circumstances permitting them good returns. Whenever shortages appear, the typical manager simply can't wait to expand capacity and thereby plug the hole through which money is showering upon him. This is precisely what insurance managers did in 1985-87, confirming

again Disraeli's observation: "What we learn from history is that we do not learn from history."

At Berkshire, we work to escape the industry's commodity economics in two ways. First, we differentiate our product by our financial strength, which exceeds that of all others in the industry. This strength, however, is limited in its usefulness. It means nothing in the personal insurance field: The buyer of an auto or homeowners policy is going to get his claim paid even if his insurer fails (as many have). It often means nothing in the commercial insurance arena: When times are good, many major corporate purchasers of insurance and their brokers pay scant attention to the insurer's ability to perform under the more adverse conditions that may exist, say, five years later when a complicated claim is finally resolved. (Out of sight, out of mind - and, later on, maybe out-of-pocket.)

Periodically, however, buyers remember Ben Franklin's observation that it is hard for an empty sack to stand upright and recognize their need to buy promises only from insurers that have enduring financial strength. It is then that we have a major competitive advantage. When a buyer really focuses on whether a \$10 million claim can be easily paid by his insurer five or ten years down the road, and when he takes into account the possibility that poor underwriting conditions may then coincide with depressed financial markets and defaults by reinsurer, he will find only a few companies he can trust. Among those, Berkshire will lead the pack.

Our second method of differentiating ourselves is the total indifference to volume that we maintain. In 1989, we will be perfectly willing to write five times as much business as we write in 1988 - or only one-fifth as much. We hope, of course, that conditions will allow us large volume. But we cannot control market prices. If they are unsatisfactory, we will simply do very little business. No other major insurer acts with equal restraint.

Three conditions that prevail in insurance, but not in most businesses, allow us our flexibility. First, market share is not an important determinant of profitability: In this business, in contrast to the newspaper or grocery businesses, the economic rule is not survival of the fittest. Second, in many sectors of insurance, including most of those in which we operate, distribution channels are not proprietary and can be easily entered: Small volume this year does not preclude huge volume next year. Third, idle capacity - which in this industry largely means people - does not result in intolerable costs. In a way that industries such as printing or steel cannot, we can operate at quarter-speed much of the time and still enjoy long-term prosperity.

We follow a price-based-on-exposure, not-on-competition policy because it makes sense for our shareholders. But we're

happy to report that it is also pro-social. This policy means that we are always available, given prices that we believe are adequate, to write huge volumes of almost any type of property-casualty insurance. Many other insurers follow an in-and-out approach. When they are "out" - because of mounting losses, capital inadequacy, or whatever - we are available. Of course, when others are panting to do business we are also available - but at such times we often find ourselves priced above the market. In effect, we supply insurance buyers and brokers with a large reservoir of standby capacity.

One story from mid-1987 illustrates some consequences of our pricing policy: One of the largest family-owned insurance brokers in the country is headed by a fellow who has long been a shareholder of Berkshire. This man handles a number of large risks that are candidates for placement with our New York office. Naturally, he does the best he can for his clients. And, just as naturally, when the insurance market softened dramatically in 1987 he found prices at other insurers lower than we were willing to offer. His reaction was, first, to place all of his business elsewhere and, second, to buy more stock in Berkshire. Had we been really competitive, he said, we would have gotten his insurance business but he would not have bought our stock.

Berkshire's underwriting experience was excellent in 1987, in part because of the lag factor discussed earlier. Our combined ratio (on a statutory basis and excluding structured settlements and financial reinsurance) was 105. Although the ratio was somewhat less favorable than in 1986, when it was 103, our profitability improved materially in 1987 because we had the use of far more float. This trend will continue to run in our favor: Our ratio of float to premium volume will increase very significantly during the next few years. Thus, Berkshire's insurance profits are quite likely to improve during 1988 and 1989, even though we expect our combined ratio to rise.

Our insurance business has also made some important non-financial gains during the last few years. Mike Goldberg, its manager, has assembled a group of talented professionals to write larger risks and unusual coverages. His operation is now well equipped to handle the lines of business that will occasionally offer us major opportunities.

Our loss reserve development, detailed on pages 41-42, looks better this year than it has previously. But we write lots of "long-tail" business - that is, policies generating claims that often take many years to resolve. Examples would be product liability, or directors and officers liability coverages. With a business mix like this, one year of reserve development tells you very little.

You should be very suspicious of any earnings figures reported by insurers (including our own, as we have unfortunately proved to you in the past). The record of the last decade shows

that a great many of our best-known insurers have reported earnings to shareholders that later proved to be wildly erroneous. In most cases, these errors were totally innocent: The unpredictability of our legal system makes it impossible for even the most conscientious insurer to come close to judging the eventual cost of long-tail claims.

Nevertheless, auditors annually certify the numbers given them by management and in their opinions unqualifiedly state that these figures "present fairly" the financial position of their clients. The auditors use this reassuring language even though they know from long and painful experience that the numbers so certified are likely to differ dramatically from the true earnings of the period. Despite this history of error, investors understandably rely upon auditors' opinions. After all, a declaration saying that "the statements present fairly" hardly sounds equivocal to the non-accountant.

The wording in the auditor's standard opinion letter is scheduled to change next year. The new language represents improvement, but falls far short of describing the limitations of a casualty-insurer audit. If it is to depict the true state of affairs, we believe the standard opinion letter to shareholders of a property-casualty company should read something like: "We have relied upon representations of management in respect to the liabilities shown for losses and loss adjustment expenses, the estimate of which, in turn, very materially affects the earnings and financial condition herein reported. We can express no opinion about the accuracy of these figures. Subject to that important reservation, in our opinion, etc."

If lawsuits develop in respect to wildly inaccurate financial statements (which they do), auditors will definitely say something of that sort in court anyway. Why should they not be forthright about their role and its limitations from the outset?

We want to emphasize that we are not faulting auditors for their inability to accurately assess loss reserves (and therefore earnings). We fault them only for failing to publicly acknowledge that they can't do this job.

From all appearances, the innocent mistakes that are constantly made in reserving are accompanied by others that are deliberate. Various charlatans have enriched themselves at the expense of the investing public by exploiting, first, the inability of auditors to evaluate reserve figures and, second, the auditors' willingness to confidently certify those figures as if they had the expertise to do so. We will continue to see such chicanery in the future. Where "earnings" can be created by the stroke of a pen, the dishonest will gather. For them, long-tail insurance is heaven. The audit wording we suggest would at least serve to put investors on guard against these predators.

The taxes that insurance companies pay - which increased materially, though on a delayed basis, upon enactment of the Tax Reform Act of 1986 - took a further turn for the worse at the end of 1987. We detailed the 1986 changes in last year's report. We also commented on the irony of a statute that substantially increased 1987 reported earnings for insurers even as it materially reduced both their long-term earnings potential and their business value. At Berkshire, the temporarily-helpful "fresh start" adjustment inflated 1987 earnings by \$8.2 million.

In our opinion, the 1986 Act was the most important economic event affecting the insurance industry over the past decade. The 1987 Bill further reduced the intercorporate dividends-received credit from 80% to 70%, effective January 1, 1988, except for cases in which the taxpayer owns at least 20% of an investee.

Investors who have owned stocks or bonds through corporate intermediaries other than qualified investment companies have always been disadvantaged in comparison to those owning the same securities directly. The penalty applying to indirect ownership was greatly increased by the 1986 Tax Bill and, to a lesser extent, by the 1987 Bill, particularly in instances where the intermediary is an insurance company. We have no way of offsetting this increased level of taxation. It simply means that a given set of pre-tax investment returns will now translate into much poorer after-tax results for our shareholders.

All in all, we expect to do well in the insurance business, though our record is sure to be uneven. The immediate outlook is for substantially lower volume but reasonable earnings improvement. The decline in premium volume will accelerate after our quota-share agreement with Fireman's Fund expires in 1989. At some point, likely to be at least a few years away, we may see some major opportunities, for which we are now much better prepared than we were in 1985.

Marketable Securities - Permanent Holdings

Whenever Charlie and I buy common stocks for Berkshire's insurance companies (leaving aside arbitrage purchases, discussed later) we approach the transaction as if we were buying into a private business. We look at the economic prospects of the business, the people in charge of running it, and the price we must pay. We do not have in mind any time or price for sale. Indeed, we are willing to hold a stock indefinitely so long as we expect the business to increase in intrinsic value at a satisfactory rate. When investing, we view ourselves as business analysts - not as market analysts, not as macroeconomic analysts, and not even as security analysts.

Our approach makes an active trading market useful, since it periodically presents us with mouth-watering opportunities. But by no means is it essential: a prolonged suspension of trading in the securities we hold would not bother us any more than does the

lack of daily quotations on World Book or Fechheimer. Eventually, our economic fate will be determined by the economic fate of the business we own, whether our ownership is partial or total.

Ben Graham, my friend and teacher, long ago described the mental attitude toward market fluctuations that I believe to be most conducive to investment success. He said that you should imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his.

Even though the business that the two of you own may have economic characteristics that are stable, Mr. Market's quotations will be anything but. For, sad to say, the poor fellow has incurable emotional problems. At times he feels euphoric and can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains. At other times he is depressed and can see nothing but trouble ahead for both the business and the world. On these occasions he will name a very low price, since he is terrified that you will unload your interest on him.

Mr. Market has another endearing characteristic: He doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow. Transactions are strictly at your option. Under these conditions, the more manic-depressive his behavior, the better for you.

But, like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence. Indeed, if you aren't certain that you understand and can value your business far better than Mr. Market, you don't belong in the game. As they say in poker, "If you've been in the game 30 minutes and you don't know who the patsy is, *you're* the patsy."

Ben's Mr. Market allegory may seem out-of-date in today's investment world, in which most professionals and academicians talk of efficient markets, dynamic hedging and betas. Their interest in such matters is understandable, since techniques shrouded in mystery clearly have value to the purveyor of investment advice. After all, what witch doctor has ever achieved fame and fortune by simply advising "Take two aspirins"?

The value of market esoterica to the consumer of investment advice is a different story. In my opinion, investment success

will not be produced by arcane formulae, computer programs or signals flashed by the price behavior of stocks and markets. Rather an investor will succeed by coupling good business judgment with an ability to insulate his thoughts and behavior from the super-contagious emotions that swirl about the marketplace. In my own efforts to stay insulated, I have found it highly useful to keep Ben's Mr. Market concept firmly in mind.

Following Ben's teachings, Charlie and I let our marketable equities tell us by their operating results - not by their daily, or even yearly, price quotations - whether our investments are successful. The market may ignore business success for a while, but eventually will confirm it. As Ben said: "In the short run, the market is a voting machine but in the long run it is a weighing machine." The speed at which a business's success is recognized, furthermore, is not that important as long as the company's intrinsic value is increasing at a satisfactory rate. In fact, delayed recognition can be an advantage: It may give us the chance to buy more of a good thing at a bargain price.

Sometimes, of course, the market may judge a business to be more valuable than the underlying facts would indicate it is. In such a case, we will sell our holdings. Sometimes, also, we will sell a security that is fairly valued or even undervalued because we require funds for a still more undervalued investment or one we believe we understand better.

We need to emphasize, however, that we do not sell holdings just because they have appreciated or because we have held them for a long time. (Of Wall Street maxims the most foolish may be "You can't go broke taking a profit.") We are quite content to hold any security indefinitely, so long as the prospective return on equity capital of the underlying business is satisfactory, management is competent and honest, and the market does not overvalue the business.

However, our insurance companies own three marketable common stocks that we would not sell even though they became far overpriced in the market. In effect, we view these investments exactly like our successful controlled businesses - a permanent part of Berkshire rather than merchandise to be disposed of once Mr. Market offers us a sufficiently high price. To that, I will add one qualifier: These stocks are held by our insurance companies and we would, if absolutely necessary, sell portions of our holdings to pay extraordinary insurance losses. We intend, however, to manage our affairs so that sales are never required.

A determination to have and to hold, which Charlie and I share, obviously involves a mixture of personal and financial considerations. To some, our stand may seem highly eccentric. (Charlie and I have long followed David Ogilvy's advice: "Develop your eccentricities while you are young. That way, when you get old, people won't think you're going ga-ga.") Certainly, in the transaction-fixated Wall Street of recent years, our posture must

seem odd: To many in that arena, both companies and stocks are seen only as raw material for trades.

Our attitude, however, fits our personalities and the way we want to live our lives. Churchill once said, "You shape your houses and then they shape you." We know the manner in which we wish to be shaped. For that reason, we would rather achieve a return of X while associating with people whom we strongly like and admire than realize 110% of X by exchanging these relationships for uninteresting or unpleasant ones. And we will never find people we like and admire more than some of the main participants at the three companies - our permanent holdings - shown below:

<i>No. of Shares</i>		<i>Cost</i>	<i>Market</i>
-----		-----	-----
		<i>(000s omitted)</i>	
3,000,000	Capital Cities/ABC, Inc.	\$517,500	\$1,035,000
6,850,000	GEICO Corporation	45,713	756,925
1,727,765	The Washington Post Company	9,731	323,092

We really don't see many fundamental differences between the purchase of a controlled business and the purchase of marketable holdings such as these. In each case we try to buy into businesses with favorable long-term economics. Our goal is to find an outstanding business at a sensible price, not a mediocre business at a bargain price. Charlie and I have found that making silk purses out of silk is the best that we can do; with sow's ears, we fail.

(It must be noted that your Chairman, always a quick study, required only 20 years to recognize how important it was to buy good businesses. In the interim, I searched for "bargains" - and had the misfortune to find some. My punishment was an education in the economics of short-line farm implement manufacturers, third-place department stores, and New England textile manufacturers.)

Of course, Charlie and I may misread the fundamental economics of a business. When that happens, we will encounter problems whether that business is a wholly-owned subsidiary or a marketable security, although it is usually far easier to exit from the latter. (Indeed, businesses can be misread: Witness the European reporter who, after being sent to this country to profile Andrew Carnegie, cabled his editor, "My God, you'll never believe the sort of money there is in running libraries.")

In making both control purchases and stock purchases, we try to buy not only good businesses, but ones run by high-grade, talented and likeable managers. If we make a mistake about the managers we link up with, the controlled company offers a certain advantage because we have the power to effect change. In practice, however, this advantage is somewhat illusory: Management changes, like marital changes, are painful, time-

consuming and chancy. In any event, at our three marketable-but permanent holdings, this point is moot: With Tom Murphy and Dan Burke at Cap Cities, Bill Snyder and Lou Simpson at GEICO, and Kay Graham and Dick Simmons at The Washington Post, we simply couldn't be in better hands.

I would say that the controlled company offers two main advantages. First, when we control a company we get to allocate capital, whereas we are likely to have little or nothing to say about this process with marketable holdings. This point can be important because the heads of many companies are not skilled in capital allocation. Their inadequacy is not surprising. Most bosses rise to the top because they have excelled in an area such as marketing, production, engineering, administration or, sometimes, institutional politics.

Once they become CEOs, they face new responsibilities. They now must make capital allocation decisions, a critical job that they may have never tackled and that is not easily mastered. To stretch the point, it's as if the final step for a highly-talented musician was not to perform at Carnegie Hall but, instead, to be named Chairman of the Federal Reserve.

The lack of skill that many CEOs have at capital allocation is no small matter: After ten years on the job, a CEO whose company annually retains earnings equal to 10% of net worth will have been responsible for the deployment of more than 60% of all the capital at work in the business.

CEOs who recognize their lack of capital-allocation skills (which not all do) will often try to compensate by turning to their staffs, management consultants, or investment bankers. Charlie and I have frequently observed the consequences of such "help." On balance, we feel it is more likely to accentuate the capital-allocation problem than to solve it.

In the end, plenty of unintelligent capital allocation takes place in corporate America. (That's why you hear so much about "restructuring.") Berkshire, however, has been fortunate. At the companies that are our major non-controlled holdings, capital has generally been well-deployed and, in some cases, brilliantly so.

The second advantage of a controlled company over a marketable security has to do with taxes. Berkshire, as a corporate holder, absorbs some significant tax costs through the ownership of partial positions that we do not when our ownership is 80%, or greater. Such tax disadvantages have long been with us, but changes in the tax code caused them to increase significantly during the past year. As a consequence, a given business result can now deliver Berkshire financial results that are as much as 50% better if they come from an 80%-or-greater holding rather than from a lesser holding.

The disadvantages of owning marketable securities are

sometimes offset by a huge advantage: Occasionally the stock market offers us the chance to buy non-controlling pieces of extraordinary businesses at truly ridiculous prices - dramatically below those commanded in negotiated transactions that transfer control. For example, we purchased our Washington Post stock in 1973 at \$5.63 per share, and per-share operating earnings in 1987 after taxes were \$10.30. Similarly, Our GEICO stock was purchased in 1976, 1979 and 1980 at an average of \$6.67 per share, and after-tax operating earnings per share last year were \$9.01. In cases such as these, Mr. Market has proven to be a mighty good friend.

An interesting accounting irony overlays a comparison of the reported financial results of our controlled companies with those of the permanent minority holdings listed above. As you can see, those three stocks have a market value of over \$2 billion. Yet they produced only \$11 million in reported after-tax earnings for Berkshire in 1987.

Accounting rules dictate that we take into income only the dividends these companies pay us - which are little more than nominal - rather than our share of their earnings, which in 1987 amounted to well over \$100 million. On the other hand, accounting rules provide that the carrying value of these three holdings - owned, as they are, by insurance companies - must be recorded on our balance sheet at current market prices. The result: GAAP accounting lets us reflect in our net worth the up-to-date underlying values of the businesses we partially own, but does not let us reflect their underlying earnings in our income account.

In the case of our controlled companies, just the opposite is true. Here, we show full earnings in our income account but never change asset values on our balance sheet, no matter how much the value of a business might have increased since we purchased it.

Our mental approach to this accounting schizophrenia is to ignore GAAP figures and to focus solely on the future earning power of both our controlled and non-controlled businesses. Using this approach, we establish our own ideas of business value, keeping these independent from both the accounting values shown on our books for controlled companies and the values placed by a sometimes foolish market on our partially-owned companies. It is this business value that we hope to increase at a reasonable (or, preferably, unreasonable) rate in the years ahead.

Marketable Securities - Other

In addition to our three permanent common stock holdings, we hold large quantities of marketable securities in our insurance companies. In selecting these, we can choose among five major categories: (1) long-term common stock investments, (2) medium-

term fixed-income securities, (3) long-term fixed income securities, (4) short-term cash equivalents, and (5) short-term arbitrage commitments.

We have no particular bias when it comes to choosing from these categories. We just continuously search among them for the highest after-tax returns as measured by "mathematical expectation," limiting ourselves always to investment alternatives we think we understand. Our criteria have nothing to do with maximizing immediately reportable earnings; our goal, rather, is to maximize eventual net worth.

- Let's look first at common stocks. During 1987 the stock market was an area of much excitement but little net movement: The Dow advanced 2.3% for the year. You are aware, of course, of the roller coaster ride that produced this minor change. Mr. Market was on a manic rampage until October and then experienced a sudden, massive seizure.

We have "professional" investors, those who manage many billions, to thank for most of this turmoil. Instead of focusing on what businesses will do in the years ahead, many prestigious money managers now focus on what they expect other money managers to do in the days ahead. For them, stocks are merely tokens in a game, like the thimble and flatiron in Monopoly.

An extreme example of what their attitude leads to is "portfolio insurance," a money-management strategy that many leading investment advisors embraced in 1986-1987. This strategy - which is simply an exotically-labeled version of the small speculator's stop-loss order dictates that ever increasing portions of a stock portfolio, or their index-future equivalents, be sold as prices decline. The strategy says nothing else matters: A downtick of a given magnitude automatically produces a huge sell order. According to the Brady Report, \$60 billion to \$90 billion of equities were poised on this hair trigger in mid-October of 1987.

If you've thought that investment advisors were hired to invest, you may be bewildered by this technique. After buying a farm, would a rational owner next order his real estate agent to start selling off pieces of it whenever a neighboring property was sold at a lower price? Or would you sell your house to whatever bidder was available at 9:31 on some morning merely because at 9:30 a similar house sold for less than it would have brought on the previous day?

Moves like that, however, are what portfolio insurance tells a pension fund or university to make when it owns a portion of enterprises such as Ford or General Electric. The less these companies are being valued at, says this approach, the more vigorously they should be sold. As a "logical" corollary, the approach commands the institutions to repurchase these companies - *I'm not making this up* - once their prices have rebounded

significantly. Considering that huge sums are controlled by managers following such Alice-in-Wonderland practices, is it any surprise that markets sometimes behave in aberrational fashion?

Many commentators, however, have drawn an incorrect conclusion upon observing recent events: They are fond of saying that the small investor has no chance in a market now dominated by the erratic behavior of the big boys. This conclusion is dead wrong: Such markets are ideal for any investor - small or large - so long as he sticks to his investment knitting. Volatility caused by money managers who speculate irrationally with huge sums will offer the true investor more chances to make intelligent investment moves. He can be hurt by such volatility only if he is forced, by either financial or psychological pressures, to sell at untoward times.

At Berkshire, we have found little to do in stocks during the past few years. During the break in October, a few stocks fell to prices that interested us, but we were unable to make meaningful purchases before they rebounded. At yearend 1987 we had no major common stock investments (that is, over \$50 million) other than those we consider permanent or arbitrage holdings. However, Mr. Market will offer us opportunities - you can be sure of that - and, when he does, we will be willing and able to participate.

- In the meantime, our major parking place for money is medium-term tax-exempt bonds, whose limited virtues I explained in last year's annual report. Though we both bought and sold some of these bonds in 1987, our position changed little overall, holding around \$900 million. A large portion of our bonds are "grandfathered" under the Tax Reform Act of 1986, which means they are fully tax-exempt. Bonds currently purchased by insurance companies are not.

As an alternative to short-term cash equivalents, our medium-term tax-exempts have - so far served us well. They have produced substantial extra income for us and are currently worth a bit above our cost. Regardless of their market price, we are ready to dispose of our bonds whenever something better comes along.

- We continue to have an aversion to long-term bonds (and may be making a serious mistake by not disliking medium-term bonds as well). Bonds are no better than the currency in which they are denominated, and nothing we have seen in the past year - or past decade - makes us enthusiastic about the long-term future of U.S. currency.

Our enormous trade deficit is causing various forms of "claim checks" - U.S. government and corporate bonds, bank deposits, etc. - to pile up in the hands of foreigners at a distressing rate. By default, our government has adopted an approach to its finances patterned on that of Blanche DuBois, of

A Streetcar Named Desire, who said, "I have always depended on the kindness of strangers." In this case, of course, the "strangers" are relying on the integrity of our claim checks although the plunging dollar has already made that proposition expensive for them.

The faith that foreigners are placing in us may be misfounded. When the claim checks outstanding grow sufficiently numerous and when the issuing party can unilaterally determine their purchasing power, the pressure on the issuer to dilute their value by inflating the currency becomes almost irresistible. For the debtor government, the weapon of inflation is the economic equivalent of the "H" bomb, and that is why very few countries have been allowed to swamp the world with debt denominated in their own currency. Our past, relatively good record for fiscal integrity has let us break this rule, but the generosity accorded us is likely to intensify, rather than relieve, the eventual pressure on us to inflate. If we do succumb to that pressure, it won't be just the foreign holders of our claim checks who will suffer. It will be all of us as well.

Of course, the U.S. may take steps to stem our trade deficit well before our position as a net debtor gets out of hand. (In that respect, the falling dollar will help, though unfortunately it will hurt in other ways.) Nevertheless, our government's behavior in this test of its mettle is apt to be consistent with its Scarlett O'Hara approach generally: "I'll think about it tomorrow." And, almost inevitably, procrastination in facing up to fiscal problems will have inflationary consequences.

Both the timing and the sweep of those consequences are unpredictable. But our inability to quantify or time the risk does not mean we should ignore it. While recognizing the possibility that we may be wrong and that present interest rates may adequately compensate for the inflationary risk, we retain a general fear of long-term bonds.

We are, however, willing to invest a moderate portion of our funds in this category if we think we have a significant edge in a specific security. That willingness explains our holdings of the Washington Public Power Supply Systems #1, #2 and #3 issues, discussed in our 1984 report. We added to our WPPSS position during 1987. At yearend, we had holdings with an amortized cost of \$240 million and a market value of \$316 million, paying us tax-exempt income of \$34 million annually.

● We continued to do well in arbitrage last year, though - or perhaps because - we operated on a very limited scale. We enter into only a few arbitrage commitments each year and restrict ourselves to large transactions that have been publicly announced. We do not participate in situations in which green-mailers are attempting to put a target company "in play."

We have practiced arbitrage on an opportunistic basis for

decades and, to date, our results have been quite good. Though we've never made an exact calculation, I believe that overall we have averaged annual pre-tax returns of at least 25% from arbitrage. I'm quite sure we did better than that in 1987. But it should be emphasized that a really bad experience or two - such as many arbitrage operations suffered in late 1987 - could change the figures dramatically.

Our only \$50 million-plus arbitrage position at yearend 1987 was 1,096,200 shares of Allegis, with a cost of \$76 million and a market value of \$78 million.

- We had two other large holdings at yearend that do not fit precisely into any of our five categories. One was various Texaco, Inc. bonds with short maturities, all purchased after Texaco went into bankruptcy. Were it not for the extraordinarily strong capital position of our insurance companies, it would be inappropriate for us to buy defaulted bonds. At prices prevailing after Texaco's bankruptcy filing, however, we regarded these issues as by far the most attractive bond investment available to us.

On a worst-case basis with respect to the Pennzoil litigation, we felt the bonds were likely to be worth about what we paid for them. Given a sensible settlement, which seemed likely, we expected the bonds to be worth considerably more. At yearend our Texaco bonds were carried on our books at \$104 million and had a market value of \$119 million.

By far our largest - and most publicized - investment in 1987 was a \$700 million purchase of Salomon Inc 9% preferred stock. This preferred is convertible after three years into Salomon common stock at \$38 per share and, if not converted, will be redeemed ratably over five years beginning October 31, 1995. From most standpoints, this commitment fits into the medium-term fixed-income securities category. In addition, we have an interesting conversion possibility.

We, of course, have no special insights regarding the direction or future profitability of investment banking. By their nature, the economics of this industry are far less predictable than those of most other industries in which we have major Commitments. This unpredictability is one of the reasons why our participation is in the form of a convertible preferred.

What we do have a strong feeling about is the ability and integrity of John Gutfreund, CEO of Salomon Inc. Charlie and I like, admire and trust John. We first got to know him in 1976 when he played a key role in GEICO's escape from near-bankruptcy. Several times since, we have seen John steer clients away from transactions that would have been unwise, but that the client clearly wanted to make - even though his advice provided no fee to Salomon and acquiescence would have delivered a large fee. Such service-above-self behavior is far from automatic in Wall

Street.

For the reasons Charlie outlines on page 50, at yearend we valued our Salomon investment at 98% of par, \$14 million less than our cost. However, we believe there is a reasonable likelihood that a leading, high-quality capital-raising and market-making operation can average good returns on equity. If so, our conversion right will eventually prove to be valuable.

Two further comments about our investments in marketable securities are appropriate. First, we give you our usual warning: Our holdings have changed since yearend and will continue to do so without notice.

The second comment is related: During 1987, as in some earlier years, there was speculation in the press from time to time about our purchase or sale of various securities. These stories were sometimes true, sometimes partially true, and other times completely untrue. Interestingly, there has been no correlation between the size and prestige of the publication and the accuracy of the report. One dead-wrong rumor was given considerable prominence by a major national magazine, and another leading publication misled its readers by writing about an arbitrage position as if it were a long-term investment commitment. (In not naming names, I am observing the old warning that it's not wise to pick fights with people who buy ink by the barrel.)

You should understand that we simply don't comment in any way on rumors, whether they are true or false. If we were to deny the incorrect reports and refuse comment on the correct ones, we would in effect be commenting on all.

In a world in which big investment ideas are both limited and valuable, we have no interest in telling potential competitors what we are doing except to the extent required by law. We certainly don't expect others to tell us of their investment ideas. Nor would we expect a media company to disclose news of acquisitions it was privately pursuing or a journalist to tell his competitors about stories on which he is working or sources he is using.

I find it uncomfortable when friends or acquaintances mention that they are buying X because it has been reported - incorrectly - that Berkshire is a buyer. However, I do not set them straight. If they want to participate in whatever Berkshire actually is buying, they can always purchase Berkshire stock. But perhaps that is too simple. Usually, I suspect, they find it more exciting to buy what is being talked about. Whether that strategy is more profitable is another question.

Financing

Shortly after yearend, Berkshire sold two issues of

debentures, totaling \$250 million. Both issues mature in 2018 and will be retired at an even pace through sinking fund operations that begin in 1999. Our overall interest cost, after allowing for expenses of issuance, is slightly over 10%. Salomon was our investment banker, and its service was excellent.

Despite our pessimistic views about inflation, our taste for debt is quite limited. To be sure, it is likely that Berkshire could improve its return on equity by moving to a much higher, though still conventional, debt-to-business-value ratio. It's even more likely that we could handle such a ratio, without problems, under economic conditions far worse than any that have prevailed since the early 1930s.

But we do not wish it to be only likely that we can meet our obligations; we wish that to be certain. Thus we adhere to policies - both in regard to debt and all other matters - that will allow us to achieve acceptable long-term results under extraordinarily adverse conditions, rather than optimal results under a normal range of conditions.

Good business or investment decisions will eventually produce quite satisfactory economic results, with no aid from leverage. Therefore, it seems to us to be both foolish and improper to risk what is important (including, necessarily, the welfare of innocent bystanders such as policyholders and employees) for some extra returns that are relatively unimportant. This view is not the product of either our advancing age or prosperity: Our opinions about debt have remained constant.

However, we are not phobic about borrowing. (We're far from believing that there is no fate worse than debt.) We are willing to borrow an amount that we believe - on a worst-case basis - will pose no threat to Berkshire's well-being. Analyzing what that amount might be, we can look to some important strengths that would serve us well if major problems should engulf our economy: Berkshire's earnings come from many diverse and well-entrenched businesses; these businesses seldom require much capital investment; what debt we have is structured well; and we maintain major holdings of liquid assets. Clearly, we could be comfortable with a higher debt-to-business-value ratio than we now have.

One further aspect of our debt policy deserves comment: Unlike many in the business world, we prefer to finance in anticipation of need rather than in reaction to it. A business obtains the best financial results possible by managing both sides of its balance sheet well. This means obtaining the highest-possible return on assets and the lowest-possible cost on liabilities. It would be convenient if opportunities for intelligent action on both fronts coincided. However, reason tells us that just the opposite is likely to be the case: Tight money conditions, which translate into high costs for

liabilities, will create the best opportunities for acquisitions, and cheap money will cause assets to be bid to the sky. Our conclusion: Action on the liability side should sometimes be taken independent of any action on the asset side.

Alas, what is "tight" and "cheap" money is far from clear at any particular time. We have no ability to forecast interest rates and - maintaining our usual open-minded spirit - believe that no one else can. Therefore, we simply borrow when conditions seem non-oppressive and hope that we will later find intelligent expansion or acquisition opportunities, which - as we have said - are most likely to pop up when conditions in the debt market are clearly oppressive. Our basic principle is that if you want to shoot rare, fast-moving elephants, you should always carry a loaded gun.

Our fund-first, buy-or-expand-later policy almost always penalizes near-term earnings. For example, we are now earning about 6 1/2% on the \$250 million we recently raised at 10%, a disparity that is currently costing us about \$160,000 per week. This negative spread is unimportant to us and will not cause us to stretch for either acquisitions or higher-yielding short-term instruments. If we find the right sort of business elephant within the next five years or so, the wait will have been worthwhile.

Miscellaneous

We hope to buy more businesses that are similar to the ones we have, and we can use some help. If you have a business that fits the following criteria, call me or, preferably, write.

Here's what we're 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. We invite potential sellers to check us out by contacting people with whom we have done business in the past. For the right business - and the right people - we can provide a good home.

On the other hand, we frequently get approached about acquisitions that don't come close to meeting our tests: new ventures, turnarounds, auction-like sales, and the ever-popular (among brokers) "I'm-sure-something-will-work-out-if-you-people-get-to-know-each-other." None of these attracts us in the least.

Besides being interested in the purchases of entire 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 Cap Cities and Salomon. We have a special interest in purchasing convertible preferreds as a long-term investment, as we did at Salomon.

* * *

And now a bit of *deja vu*. Most of Berkshire's major stockholders received their shares at yearend 1969 in a liquidating distribution from Buffett Partnership, Ltd. Some of these former partners will remember that in 1962 I encountered severe managerial problems at Dempster Mill Manufacturing Co., a pump and farm implement manufacturing company that BPL controlled.

At that time, like now, I went to Charlie with problems that were too tough for me to solve. Charlie suggested the solution might lie in a California friend of his, Harry Bottle, whose special knack was never forgetting the fundamental. I met Harry in Los Angeles on April 17, 1962, and on April 23 he was in Beatrice, Nebraska, running Dempster. Our problems disappeared almost immediately. In my 1962 annual letter to partners, I named Harry "Man of the Year."

Fade to 24 years later: The scene is K & W Products, a small Berkshire subsidiary that produces automotive compounds. For years K & W did well, but in 1985-86 it stumbled badly, as it pursued the unattainable to the neglect of the achievable. Charlie, who oversees K & W, knew there was no need to consult me. Instead, he called Harry, now 68 years old, made him CEO, and sat back to await the inevitable. He didn't wait long. In 1987 K & W's profits set a record, up more than 300% from 1986. And, as profits went up, capital employed went down: K & W's investment in accounts receivable and inventories has decreased 20%.

If we run into another managerial problem ten or twenty years down the road, you know whose phone will ring.

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About 97.2% of all eligible shares participated in Berkshire's 1987 shareholder-designated contributions program. Contributions made through the program were \$4.9 million, and 2,050 charities were recipients.

A recent survey reported that about 50% of major American companies match charitable contributions made by directors (sometimes by a factor of three to one). In effect, these representatives of the owners direct funds to their favorite charities, and never consult the owners as to their charitable preferences. (I wonder how they would feel if the process were reversed and shareholders could invade the directors' pockets for charities favored by the shareholders.) When A takes money from B to give to C and A is a legislator, the process is called taxation. But when A is an officer or director of a corporation, it is called philanthropy. We continue to believe that contributions, aside from those with quite clear direct benefits to the company, should reflect the charitable preferences of owners rather than those of officers and directors.

We urge new shareholders to read the description of our shareholder-designated contributions program that appears on pages 54 and 55. If you wish to participate in future programs, we strongly urge that you immediately make sure your shares are registered in the name of the actual owner, not in "street" name or nominee name. Shares not so registered on September 30, 1988 will be ineligible for the 1988 program.

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Last year we again had about 450 shareholders at our annual meeting. The 60 or so questions they asked were, as always, excellent. At many companies, the annual meeting is a waste of time because exhibitionists turn it into a sideshow. Ours, however, is different. It is informative for shareholders and fun for us. (At Berkshire's meetings, the exhibitionists are on the dais.)

This year our meeting will be on May 23, 1988 in Omaha, and we hope that you come. The meeting provides the forum for you to ask any owner-related questions you may have, and we will keep answering until all (except those dealing with portfolio activities or other proprietary information) have been dealt with.

Last year we rented two buses - for \$100 - to take shareholders interested in the trip to the Furniture Mart. Your actions demonstrated your good judgment: You snapped up about \$40,000 of bargains. Mrs. B regards this expense/sales ratio as on the high side and attributes it to my chronic inattention to costs and generally sloppy managerial practices. But, gracious

as always, she has offered me another chance and we will again have buses available following the meeting. Mrs. B says you must beat last year's sales figures, and I have told her she won't be disappointed.

February 29, 1988

Warren E. Buffett
Chairman of the Board