Warren Buffett and the $300,000 Haircut

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By Jason Zweig

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This Sunday, Warren Buffett turns 90.

The chairman of Berkshire Hathaway Inc. BRK.B 0.77% is one of the most successful investors of all time, having amassed a net worth estimated at $82 billion. Yet he accrued nearly 90% of that sum after the age of 65. Investing well is important, but investing well for a long time matters even more.

"I've long recommended," Mr. Buffett told me in an email earlier this month, "what I called 'The Methuselah Technique.' " That, as he explained in a letter he wrote to the investors in his limited partnership on Jan. 18, 1965, is the combination of a long life and a stable, attractive investment return. Mr. Buffett made his first investment, three shares of Cities Service Co., more than 78 years ago.

Buffett's Letter

Read the relevant portion of the 1965 letter to investors, provided by Mr. Buffett

“The model seems to be working,” Mr. Buffett quipped in his email, “but I’m only about 9% of the way home.” (At 90, he will be approximately 9% of the age of 969 ascribed to Methuselah in the Bible.)

From the earliest age, Mr. Buffett has understood that building wealth depends not only on how much your money grows, but also on how long it grows.

Around the age of 10, he read a book about how to make $1,000 and intuitively grasped the importance of time. In five years, $1,000 earning 10% would be worth more than $1,600; 10 years of 10% growth would turn it into nearly $2,600; in 25 years, it would amount to more than $10,800; in 50 years, it would compound to almost $117,400.

“That’s where the money is,” he recalls telling himself, according to “The Snowball,” Alice Schroeder’s biography of Mr. Buffett.

“The way that numbers exploded as they grew at a constant rate over time was how a small sum could turn into a fortune,” Ms. Schroeder wrote about his epiphany as a boy. “He could picture the numbers compounding as vividly as the way a snowball grew when he rolled it across the lawn.”

That isn’t easy for most of us to do. People severely underestimate the power of compound growth, and those errors worsen over longer time horizons and for higher rates of return.

Here’s a quick quiz inspired by Warren Buffett. If the Dow Jones Industrial Average, about 28500 this week, compounds at slightly under 1.6% annually, what will its value be on Dec. 31, 2099?

The answer: That would take the Dow to 100,000.

What if the Dow earns an average of 4.6% annually?

That would bring the index to 1,000,000 by the end of the century.

Now imagine that the Dow compounds at 7.7% annually—still below its 8.4% average over the past 30 years. That would push the Dow Jones Industrial Average past 10,000,000 by Dec. 31, 2099.

Those rates of return don’t include any boost from dividends. They also assume an investor takes a diversified approach. Concentrating on only a handful of investments and holding them for years or decades has generated huge gains for Mr. Buffett, but may create nothing but heartache for investors who aren’t as knowledgeable.

If you don’t find those results surprising, you’re either as good at math as Mr. Buffett is, or you have been reading too fast. Even at low to moderate rates of return, long periods of continuous growth turn small amounts into mountains of money. That’s vital for investors to remember when more speculators than ever seem to be hanging on to stocks for only days or hours at a time.

Mr. Buffett's long career offers another lesson: Be flexible. The older he gets, the less he invests the way he used to.

SHARE YOUR THOUGHTS

How has your approach to investing changed over time? Join the conversation below.

Mr. Buffett earned his greatest returns decades ago buying the tiniest, cheapest stocks he could find, market microorganisms like water-pump producer Dempster Mill Manufacturing Co. and cartography firm Sanborn Map Co.

Nowadays Berkshire Hathaway's biggest holding is giant Apple Inc. It wasn't Mr. Buffett who originally bought it for Berkshire's portfolio—one of his lieutenants did—but he became more enthusiastic about the investment over time.

This week, the Apple stake held by Mr. Buffett's company was worth about $123 billion, or 24% of Berkshire's total market value—a stunning turnabout for an investor who long refused to invest in technology stocks because he felt he didn't understand them.

Across the market overall, Apple's shares turn over at an annual rate of 211%, estimates AJO, an investment firm in Philadelphia. This means the typical investor holds the stock for less than 25 weeks. Berkshire has held Apple for 4½ years, with no end in sight.

Before he was even a teenager, wrote Ms. Schroeder, his biographer, "Warren began to think about time in a different way. Compounding married the present to the future. If a dollar today was going to be worth 10 some years from now, then in his mind the two were the same."

By the time he was in his late 20s, the way Mr. Buffett thought about compounding was like a reflex. When he paid $31,500 for his house in Omaha, he called it "Buffett's Folly," because "in his mind $31,500 was a million dollars after compounding" into the future, Ms. Schroeder wrote.

His friends and family regularly heard the young Mr. Buffett mutter things like "Do I really want to spend $300,000 for this haircut?" or "I'm not sure I want to blow $500,000 that way" when pondering whether to spend a few bucks. To him, a few dollars spent that day were hundreds of thousands of dollars forgone in the future because they couldn't compound.

Recognizing that every dollar you spend today is $10 or $100 or $1,000 you won't have in the future doesn't have to make you a miser. It teaches you to acknowledge the importance of measuring trade-offs. You should always weigh the need or desire that today's spending fulfills against what you could accomplish with that money after letting it grow for years or decades into the future. And the more often you trade, the more likely you are to disrupt compounding and to have to start all over again.

Now more than ever, as Mr. Buffett continues to show, patience and endurance are investing superpowers.

Write to Jason Zweig at intelligentinvestor@wsj.com to evaluate the conversativeness of past policies is to study performance in declining markets. We have only three years of declining markets in our table and unfortunately (for purposes of this test only) they were all moderate declines. In all three of these years we achieved appreciably better investment results than any of the more conventional portfolios.

Specifically, if those three years had occurred in sequence, the cumulative results would have been:

Tri-Continental Corp.	- 9.7%
Dow	-20.6
Mass. Investors Trust	-20.9
Lehman Corp.	-22.3
Investors Stock Fund	-24.6
Limited Partners	+45.0

We don't think this comparison is all important, but we do think it has some relevance. We certainly think it makes more sense than saying "We own (regardless of price) A. T. & T., General Electric, IBM and General Motors and are therefore conservative." In any event, evaluation of the conservatism of any investment program or management (including self-management) should be based upon rational objective standards, and I suggest performance in declining markets to be at least one meaningful test.

The Joys of Compounding

Readers of our early annual letters registered discontent at a mere recital of contemporary investment experience, but instead hungered for the intellectual stimulation that only could be provided by a depth study of investment strategy spanning the centuries. Hence, this section.

Our last two excursions into the mythology of financial expertise have revealed that purportedly shrewd investments by Isabella (backing the voyage of Columbus) and Francis I (original purchase of Mona Lisa) bordered on fiscal lunacy. Apologists for these parties have presented an array of sentimental trivia. Through it all, our compounding tables have not been dented by attack.

Nevertheless, one criticism has stung a bit. The charge has been made that this column has acquired a negative tone with only the financial incompetents of history receiving comment. We have been challenged to record on these pages a story of financial perspicacity which will be a bench mark of brilliance down through the ages.

One story stands out. This, of course, is the saga of trading acumen etched into history by the Manhattan Indians when they unloaded their island to that notorious spendthrift, Peter Minuit in 1626. My understanding is that they received $24 net. For this, Minuit received 22.3 square miles which works out to about 621,688,320 square feet. While on the basis of comparable sales, it is difficult to arrive at a precise appraisal, a $20 per square foot estimate seems reasonable giving a current land value for the island of $12,433,766,400 ($12 1/2 billion). To the novice, perhaps this sounds like a decent deal. However, the Indians have only had to achieve a 6 1/2% return (The tribal mutual fund representative would have promised them this.) to obtain the last laugh on Minuit. At 6 1/2%, $24 becomes $42,105,772,800 ($42 billion) in 338 years, and if they just managed to squeeze out an extra half point to get to 7%, the present value becomes $205 billion.

So much for that.

Some of you may view your investment policies on a shorter term basis. For your convenience, we include our usual table indicating the gains from compounding $100,000 at various rates:

	4%	8%	12%	16%
10 years	$ 48,024	$115,892	$ 210,584	$ 341,143
20 years	119,111	366,094	864,627	1,846,060
30 years	224,337	906,260	2,895,970	8,484,940

This table indicates the financial advantages of:

(1) A long life (in the erudite vocabulary of the financial sophisticate this is referred to as the Methusalah Technique)

(2) A high compound rate

(3) A combination of both (especially recommended by this author)

To be observed are the enormous benefits produced by relatively small gains in the annual earnings rate. This explains our attitude which, while hopeful of achieving a striking margin of superiority over average investment results, nevertheless, regards every percentage point of investment return above average as having real meaning.

Our Goal

You will note that there are no columns in the preceding table for the 27.7% average of the Partnership during its eight-year lifespan or the 22.3% average of the limited partners. Such figures are nonsensical for the long term for several reasons: (Don't worry about me "holding back" to substantiate this prophecy.)

(1) Any significant sums compounded at such rates take on national debt proportions at alarming speed.