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The Ground Rules

Some partners have confessed (that's the proper word) that they sometimes find it difficult to wade through my entire annual letter. Since I seem to be getting more long-winded each year, I have decided to emphasize certain axioms on the first pages. Everyone should be entirely clear on these points. To most of you this material will seem unduly repetitious, but I would rather have nine partners out of ten mildly bored than have one out of ten with any basic misconceptions.

1. In no sense is any rate of return guaranteed to partners. Partners who withdraw one-half of 1% monthly are doing just that--withdrawing. If we earn more than 6% per annum over a period of years the withdrawals will be covered by earnings and the principal will increase. If we don't earn 6%, the monthly payments are partially or wholly a return of capital.
2. Any year in which we fail to achieve at least a plus 6% performance will be followed by a year when partners receiving monthly payments will find those payments lowered.
3. Whenever we talk of yearly gains or losses, we are talking about market values; that is, how we stand with assets valued at market at yearend against how we stood on the same basis at the beginning of the year. This may bear very little relationship to the realized results for tax purposes in a given year.
4. Whether we do a good job or a poor job is not to be measured by whether we are plus or minus for the year. It is instead to be measured against the general experience in securities as measured by the Dow-Jones Industrial Average, leading investment companies etc. If our record is better than that of these yardsticks, we consider it a good year whether we are plus or minus. If we do poorer we deserve the tomatoes.
5. While I much prefer a five-year test, I feel three years is an absolute minimum for judging performance. It is a certainty that we

will have years when the partnership performance is poorer, perhaps substantially so, than the Dow. If any three-year or longer period produces poor results, we all should start looking around for other places to have our money. An exception to the latter statement would be three years covering a speculative explosion in a bull market.

6. I am not in the business of predicting general stock market or business fluctuations. If you think I can do this, or think it is essential to an investment program, you should not be in the partnership.
7. I cannot promise results to partners. What I can and do promise is that:
 - a. Our investments will be chosen on the basis of value, not popularity;
 - b. That we will attempt to bring risk of permanent capital loss (not short-term quotational loss) to an absolute minimum by obtaining a wide margin of safety in each commitment and a diversity of commitments; and
 - c. My wife; children and I will have virtually our entire net worth invested in the partnership.

Our Performance in 1962

I have consistently told partners that we expect to shine on a relative basis during minus years for the Dow, whereas plus years of any magnitude may find us blushing. This held true in 1962.

Because of a strong rally in the last few months, the general market as measured by the Dow really did not have such a frightening decline as many might think. From 731 at the beginning of the year, it dipped to 535 in June, but closed at 652. At the end of 1960, the Dow stood at 616, so you can see that while there has been a good deal of action the past few years, the investing public as a whole is not too far from where it was in 1959 or 1960. If

~~the Dow had stayed at 535, I imagine there are a few people play-~~

<u>Year</u>	<u>Over-all Results from Dow</u>	<u>Partnership Results (1)</u>	<u>Limited Partner Results (2)</u>
1957	- 8.4%	+10.4%	+ 9.3%
1958	+38.5	+40.9	+32.2
1959	+20.0	+25.9	+20.9
1960	- 6.2	+22.8	+18.6
1961	+22.4	+45.9	+35.9
1962	- 7.6	+13.9	+11.9

(1) For 1957-61 consists of combined results of all predecessor limited partnerships operating throughout entire year after all expenses but before distributions to partners or allocations to the general partner.

(2) For 1957-61 computed on basis of preceding column of partnership results allowing for allocation to general partner based upon present partnership agreement.

The following table shows the cumulative or compounded results in the same three categories, as well as the average annual compounded rate:

<u>Year</u>	<u>Over-all Results from Dow</u>	<u>Partnership Results</u>	<u>Limited Partner Results</u>
1957	- 8.4%	+ 10.4%	+ 9.3%
1957-8	+ 26.9	+ 55.6	+ 44.5
1957-9	+ 52.3	+ 95.9	+ 74.7
1957-60	+ 42.9	+140.6	+107.2
1957-61	+ 74.9	+251.0	+181.6
1957-62	+ 61.6	+299.8	+215.1
Annual Compounded Rate	8.3	26.0	21.1

My (unscientific) opinion is that a margin of ten percentage points per annum over the Dow is the very maximum that can be achieved with invested funds over any long period of years, so it may be well to mentally modify some of the above figures.

Partners have sometimes expressed concern as to the effect of size upon performance. This subject was reflected upon in last year's annual letter. The conclusion reached was that there were some situations where larger size helped and some where they hindered, but on balance, I did not feel they penalize performance. I promised to inform partners if my conclusions should change. At the beginning of 1957, combined limited partnership assets totaled \$303,726 and grew to \$7,178,500 at the beginning of 1962. To date, anyway, our margin over the Dow has indicated no tendency to narrow as funds increase.

Investment Companies

Along with the results of the Dow, we have regularly included the tabulations on the two largest open-end investment companies (mutual funds) following a common stock policy, and the two largest diversified closed-end investment companies. These four companies, Massachusetts Investors Trust, Investors Stock Fund, Tri-Continental Corp. and Lehman Corp. manage over \$3 billion and are probably typical of most of the \$20 billion investment company industry. My opinion is that their results parallel those of most bank trust departments and investment counseling organizations which handle, in aggregate, vastly greater sums.

The purpose of this tabulation, which is shown below, is to illustrate that the Dow is no pushover as an index of investment achievement. The advisory talent managing just the four companies shown commands annual fees of approximately \$7 million, and this represents a very small fraction of the industry. Nevertheless, the public batting average of this highly-paid talent indicates results slightly less favorable than the Dow. In no sense is this statement intended as criticism. Within their institutional framework and handling the many billions of dollars involved, I consider such average results virtually the only possible ones. Their merits lie in other than superior results.

Both our portfolio and method of operation differ substantially from the companies mentioned above. However, most partners, as an alternative to their interest in the partnership would probably have their funds invested in media producing results comparable with investment companies, and I, therefore, feel they offer a meaningful test of performance.

YEARLY RESULTS

<u>Year</u>	<u>Mass. Inv. Trust (1)</u>	<u>Investors Stock (1)</u>	<u>Lehman (2)</u>	<u>Tri-Cont. (2)</u>	<u>Dow</u>	<u>Lin Par</u>
1957	-11.4%	-12.4%	-11.4%	- 2.4%	- 8.4%	+
1958	+42.7	+47.5	+40.8	+33.2	+38.5	+
1959	+ 9.0	+10.3	+ 8.1	+ 8.4	+20.0	+
1960	- 1.0	- 0.6	+ 2.5	+ 2.8	- 6.2	+
1961	+25.6	+24.9	+23.6	+22.5	+22.4	+
1962	- 9.8	-13.4	-13.0	-10.0	- 7.6	+

(1) Computed from changes in asset value plus any distributions to holders of record during year.

(2) From 1962 Moody's Bank & Finance Manual for 1957-61.
Estimated for 1962.

COMPOUNDED

Mass. Inv. Investors

1

1957	-11.4%	-12.4%	-11.4%	- 2.4%	- 8.4%
1957-8	+26.4	+29.2	+24.7	+30.0	+26.9
1957-9	+37.8	+42.5	+34.8	+40.9	+52.3
1957-60	+36.4	+41.6	+38.2	+44.8	+42.9
1957-61	+71.3	+76.9	+70.8	+77.4	+74.9
1957-62	+54.5	+53.2	+48.6	+59.7	+61.6
Annual Com- pounded Rate	7.5	7.4	6.8	8.1	8.3

The Joys of Compounding

I have it from unreliable sources that the cost of the voyage Isabella original underwrote for Columbus was approximately \$30,000. This has been consid at least a moderately successful utilization of venture capital. Without atter ing to evaluate the psychic income derived from finding a new hemisphere, i must be pointed out that even had squatter's rights prevailed, the whole deal

in any given year. The actual percentage division among categories is to some degree planned, but to a great extent, accidental, based upon availability factors.

The first section consists of generally undervalued securities (hereinafter called "generals") where we have nothing to say about corporate policies and no timetable as to when the undervaluation may correct itself. Over the years, this has been our largest category of investment, and more money has been made here than in either of the other categories. We usually have fairly large positions (5% to 10% of our total assets) in each of five or six generals, with smaller positions in another ten or fifteen.

Sometimes these work out very fast; many times they take years. It is difficult at the time of purchase to know any compelling reason why they should appreciate in price. However, because of this lack of glamour or anything pending which might create immediate favorable market action, they are available at very cheap prices. A lot of value can be obtained for the price paid. This substantial excess of value creates a comfortable margin of safety in each transaction. Combining this individual margin of safety with a diversity of commitments creates a most attractive package of safety and appreciation potential. We do not go into these generals with the idea of getting the last nickel, but are usually quite content selling out at some intermediate level between our purchase price and what we regard as fair value to a private owner.

Many times generals represent a form of "coattail riding" where we feel the dominating stockholder group has plans for the conversion of unprofitable or under-utilized assets to a better use. We have done that ourselves in Sanborn and Dempster, but everything else equal, we would rather let others do the work. Obviously, not only do the values have to be ample in a case like this, but we also have to be careful whose coat we are holding.

The generals tend to behave market-wise very much in sympathy with the Dow. Just because something is cheap does not mean it is not going to go down. During abrupt downward movements in the market, this segment may very well go down percentage-wise just as much as the Dow. Over a period of years, I believe the generals will outperform the Dow, and during sharply advancing years like 1961, this is the section of our portfolio that turns in the best results. It is, of course, also the most vulnerable in a declining

etc., lead to work-outs. An important source in recent years has been sell-outs by oil producers to major integrated oil companies.

This category will produce reasonably stable earnings from year to year, to a large extent irrespective of the course of the Dow. Obviously, if we operate throughout a year with a large portion of our portfolio in work-outs, we will look extremely good if it turns out to be a declining year for the Dow or quite bad if it is a strongly advancing year.

We were fortunate in that we had a good portion of our portfolio in work-outs in 1962. As I have said before, this was not due to any notion on my

part as to what the market would do, but rather because I could get more of what I wanted in this category than in the generals. This same concentration in work-outs hurt our performance during the market advance in the second half of the year.

Over the years, work-outs have provided our second largest category. At any given time, we may be in five to ten of these; some just beginning and others in the late stage of their development. I believe in using borrowed money to offset a portion of our work-out portfolio, since there is a high degree of safety in this category in terms of both eventual results and intermediate market behavior. For instance, you will note when you receive our audit report, that we paid \$75,000 of interest to banks and brokers during the year. Since our borrowing was at approximately 5%, this means we had an average of \$1,500,000 borrowed from such sources. Since 1962 was a down year in the market, you might think that such borrowing would hurt results. However, all of our loans were to offset work-outs, and this category turned in a good profit for the year. Results, excluding the benefits derived from the use of borrowed money, usually fall in the 10% to 20% per

well happen. Usually, it moves up before we have a substantial percentage of the company's stock, and we sell at higher levels and complete a successful general operation.

Dempster Mill Manufacturing Company

The high point of 1962 from a performance standpoint was our present control situation -- 73% owned Dempster Mill. Dempster has been primarily in farm implements (mostly items retailing for \$1,000 or under), water systems, water well supplies and jobbed plumbing lines.

The operations for the past decade have been characterized by static sales, low inventory turnover and virtually no profits in relation to invested capital.

We obtained control in August, 1961 at an average price of about \$28 per share, having bought some stock as low as \$16 in earlier years, but the vast majority in an offer of \$30.25 in August. When control of a company is obtained, obviously what then becomes all-important is the value of assets, not the market quotation for a piece of paper (stock certificate).

Last year, our Dempster holding was valued by applying what I felt were appropriate discounts to the various assets. These valuations were based on their status as non-earning assets, and were not assessed on the basis of potential, but on the basis of what I thought a prompt sale would produce at that date. Our job was to compound these values at a decent rate. The consolidated balance sheet last year and the calculation of fair value are shown below.

(000's omitted)

<u>Assets</u>	<u>Book Figure</u>	<u>Valued @</u>	<u>Adjusted Valuation</u>	<u>Liabilities</u>	
Cash	\$ 166	100%	\$ 166	Notes payable	\$1,230
Accts. rec. (net)	1,040	85	884		
Inventory	4,203	60	2,522	Other liabilities	1,088
Ppd. exp. etc.	82	25	21		
Current assets	<u>5,491</u>		<u>3,593</u>	Total liabilities	<u>2,318</u>
Cash value life ins., etc.	45	100	45	Net worth:	
Net plant & equipment	1,383	Est. net auction value	800	Per books	4,600
				As adjusted to quickly realizable values	2,120
Total assets	<u>\$6,919</u>		<u>\$4,438</u>	Shares outstanding 60,146	
				Adj. value per share	<u>\$35.2</u>

Dempster's fiscal year ends November 30th, and because the audit was unavailable in complete form, I approximated some of the figures and rounded to \$35 per share last year.

Initially, we worked with the old management toward more effective utilization of capital, better operating margins, reduction of overhead, etc. These efforts were completely fruitless. After spinning our wheels for about six months, it became obvious that while lip service was being given to our objective, either through inability or unwillingness, nothing was being accomplished. A change was necessary.

A good friend, whose inclination is not toward enthusiastic descriptions, highly recommended Harry Bottle for our type of problem. On April 17, 1962, I met Harry in Los Angeles, presented a deal which provided for rewards to him based upon our objectives being met, and on April 23rd he was sitting in the president's chair in Beatrice.

Harry is unquestionably the man of the year. Every goal we have set for Harry has been met, and all the surprises have been on the pleasant side. He has accomplished one thing after another that has been labeled as impossible, and has always taken the tough things first. Our breakeven point has been cut virtually in half, slow-moving or dead merchandise has been sold or written off, marketing procedures have been revamped, and unprofitable facilities have been sold.

The results of this program are partially shown in the balance sheet below, which, since it still represents non-earning assets, is valued on the same basis as last year. (000's omitted)

<u>Assets</u>	<u>Book Figure</u>	<u>Valued @</u>	<u>Adjusted Valuation</u>	<u>Liabilities</u>	
Cash	\$ 60	100% Mkt.	\$.60	Notes payable	\$ -
Marketable securities	758	12/31/62	834	Other liabilities	3
Accts. rec. (net)	786	85%	676		
Inventory	1,634	60	981	Total liabilities	<u>3</u>
Cash value life ins.	41	100	41	Net worth:	
Recoverable income tax	170	100	170	Per books	4,0
Ppd. exp. etc.	14	25	4	As adjusted to quickly realizable values	3,1
Current assets	<u>3,473</u>		<u>2,766</u>	Add: proceeds from potential exercise of option to Harry Bottle	<u>3,</u>
Misc. invest.	5	100	5	Shares outstanding 60,146	
Net plant & equipment	845	Est. net auction value	700	Add: sha. potentially outstanding under option	<u>2,000</u>
Total assets	<u>\$4,423</u>		<u>\$3,471</u>	Total	62,146
				Adj. value per share	<u>\$51</u>

On January 2, 1963, Dempster received an unsecured term loan of \$1,250,000. These funds, together with the funds all ready "freed-up" will enable us to have a security portfolio of about \$35 per share at Dempster, or considerably more than we paid for the whole company. Thus our present valuation will

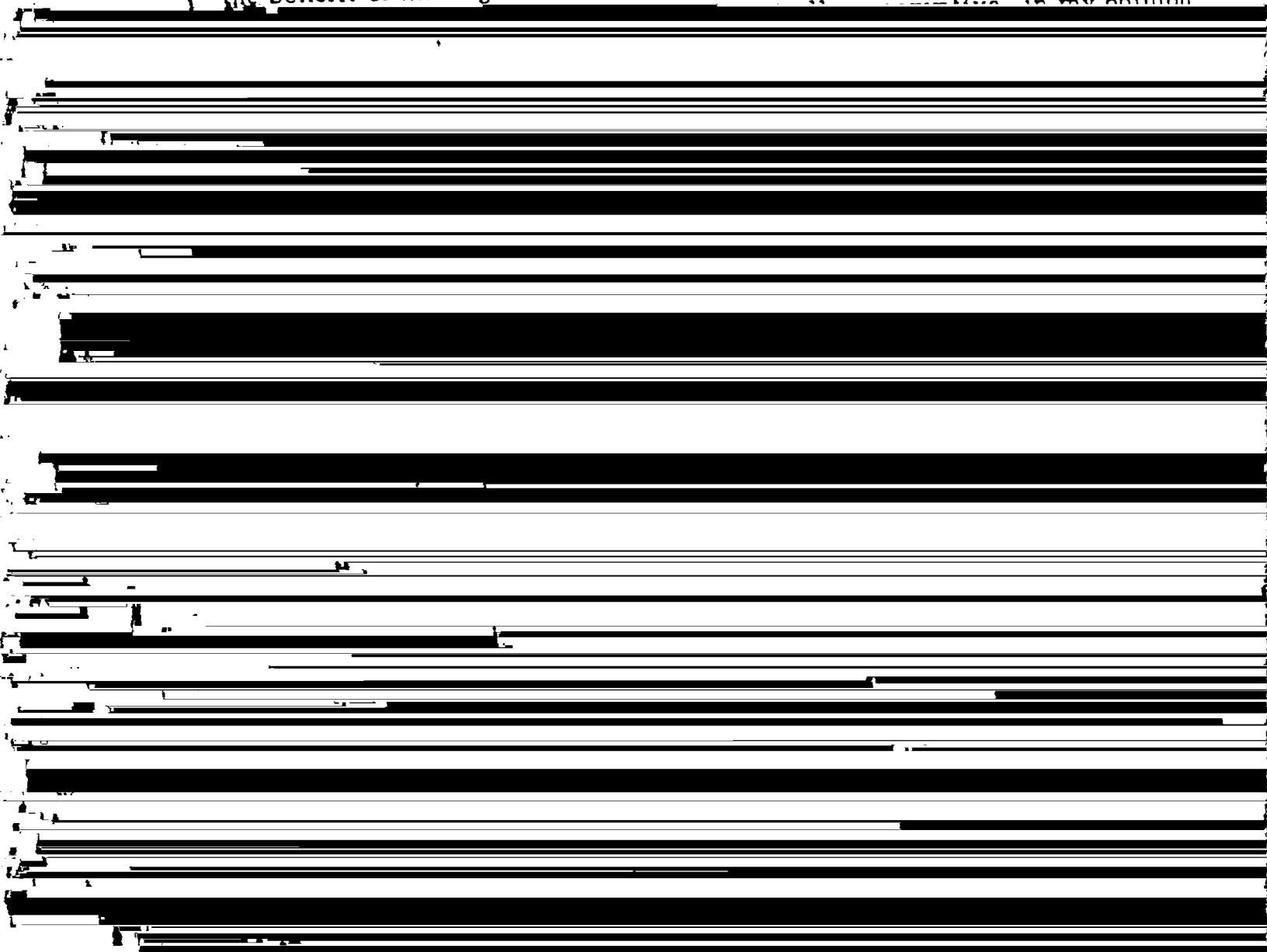
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The Question of Conservatism

Because I believe it may be even more meaningful after the events of 1962, I would like to repeat this section from last year's letter:

"The above description of our various areas of operation may provide some clues as to how conservatively our portfolio is invested. Many people some years back thought they were behaving in the most conservative manner by purchasing medium or long-term municipal or government bonds. This policy has produced substantial market depreciation in many cases, and most certainly has failed to maintain or increase real buying power.

"Conscious, perhaps overly conscious, of inflation, many people now feel that they are behaving in a conservative manner by buying blue chip securities almost regardless of price-earnings ratios, dividend yields, etc. Without the benefit of hindsight as in the bond example, I feel this course of action is not conservative in my opinion.



to more conventional (often termed conservative which is not synonymous) methods of common stock investing, it would appear that our method involved considerably less risk. Our advantage over the Dow was all achieved when the market was going down; we lost a bit of this edge on the way up.

The Usual Prediction

I am certainly not going to predict what general business or the stock market are going to do in the next year or two, since I don't have the faintest idea.

I think you can be quite sure that over the next ten years, there are going to be a few years when the general market is plus 20% or 25%, a few when it is minus on the same order, and a majority when it is in between. I haven't any notion as to the sequence in which these will occur, nor do I think it is of any great importance for the long-term investor. If you will take the first table on page 3 and shuffle the years around, the compounded result will stay the same. If the next four years are going to involve, say, a +40%, -30%, +10% and -6%, the order in which they fall is completely unimportant for our purposes as long as we all are around at the end of the four years. Over a long period of years, I think it likely that the Dow will probably produce something like 5% per year compounded from a combination of dividends and market value gain. Despite the experience of the last decade, anyone expecting substantially better than that from the general market probably faces disappointment.

Our job is to pile up yearly advantages over the performance of the Dow without worrying too much about whether the absolute results in a given year are minus. I would consider a year in which we were down

Miscellaneous

This year marked the transition from the office off the bedroom to one a bit (quite a bit) more conventional. Surprising as it may seem, the return to the office has not been unpleasant. As a matter of fact, I enjoy

Bill Scott who has fit into our operation splendidly has an interest (with his wife) of \$167,400.00, a very large portion of his net worth. So we are all eating our own cooking.

You will note from the auditor's certificate that they made a surprise check