Preface

The original edition of *The Essays of Warren Buffett: Lessons for Corporate America* was the centerpiece of a symposium held two decades ago at the Benjamin N. Cardozo School of Law under the auspices of its Samuel and Ronnie Heyman Center on Corporate Governance. This gathering brought hundreds of Cardozo students together for a two-day dissection of all the ideas in the collection, featuring a series of vibrant debates among some 30 distinguished professors, investors, managers, and other students, with Warren E. Buffett and Charles T. Munger participating throughout from their seats in the front row.

The Essays was the standard textbook for a specialized course I taught at Cardozo in proper business practices and is adopted by scores of professors at other law and business schools for classes such as investment, finance and accounting. Some investment firms have distributed copies to their professional employees and clients as part of training programs. I am grateful for the positive feedback from these students, teachers, and other users and delighted to know that the lessons are being taught and learned. Special thanks to Professor Tom Johansen (Ft. Hays State University, Kansas) and Professor Leo Chan (Delaware State College).

Continuing thanks also to Mr. Buffett's good friend and advisor, Robert Denham, whom I have had the pleasure of getting to know in the years following the symposium. Mr. Denham, a partner in the law firm Munger, Tolles & Olsen, introduced Mr. Buffett to Cardozo and me through another mutual friend, former Munger, Tolles colleague and now Cardozo professor Monroe Price, and I thank both of them for opening that door. Thanks also to Carol Loomis, a close friend of Mr. Buffett's and the person who annually edits each shareholder letter. For institutional support in countless ways, thanks as always to Sam and Ronnie Heyman.

As in previous editions of *The Essays*, this one retains the architecture and philosophy of the original edition but adds selections from Mr. Buffett's most recent annual shareholder letters. All the letters are woven together into a fabric that reads as a complete and coherent narrative of a sound business and investment philosophy. As an aid to all readers, and to enable readers of the previous editions to see what is new in this one, a disposition table at the end of the book shows the various places in this collection where selections from each year's letter appear. Footnotes throughout indicate the year of the annual report from which essays are taken. To avoid interrupting the narrative flow in this collection, omissions of text within excerpts are not indicated by ellipses or other punctuation.

The new edition is called for not because anything has changed about the fundamentals of sound business and investment philosophy but because Mr. Buffett's articulation of that philosophy is always done in the context of contemporary events and business conditions. So periodic updating is warranted to maintain its currency.

In preparing the previous editions, I was aided by numerous people, to whom I expressed gratitude in those editions, and I want to thank them again. Among those, I especially thank Mr. Buffett. His generosity not only made the symposium possible but his participation enriched it manifold; his willingness to entrust the rearrangement and republication of his letters to me is a great honor. His partner, Charlie Munger, deserves repeated thanks too, for not only did he participate in the symposium from the front row he also graciously chaired, on a moment's notice, one of the panels.

Lawrence A. Cunningham

New York City
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INTRODUCTION

Lawrence A. Cunningham

Experienced readers of Warren Buffett's letters to the shareholders of Berkshire Hathaway Inc. have gained an enormously valuable informal education. The letters distill in plain words all the basic principles of sound business practices. On selecting managers and investments, valuing businesses, and using financial information profitably, the writings are broad in scope, and long on wisdom. By arranging these writings as thematic essays, this collection presents a synthesis of the overall business and investment philosophy intended for dissemination to a wide general audience.

The central theme uniting Buffett's lucid essays is that the principles of fundamental business analysis, first formulated by his teachers Ben Graham and David Dodd, should guide investment practice. Linked to that theme are management principles that define the proper role of corporate managers as the stewards of invested capital, and the proper role of shareholders as the suppliers and owners of capital. Radiating from these main themes are practical and sensible lessons on the entire range of important business issues, from accounting to mergers to valuation.

Buffett has applied these traditional principles as chief executive officer of Berkshire Hathaway, a company with roots in a group of textile operations begun in the early 1800s. Buffett took the helm of Berkshire in 1964, when its book value per share was $19.46 and its intrinsic value per share far lower. Today, its book value per share is around $100,000 and its intrinsic value far higher. The growth rate in book value per share during that period is about 20% compounded annually.

Berkshire is now a holding company engaged in 80 distinct business lines. Berkshire's most important business is insurance, carried on through various companies including its 100% owned subsidiary, GEICO Corporation, among the largest auto insurers in the United States, and General Re Corporation, one of the largest reinsurers in the world. In 2010, Berkshire acquired Burlington Northern Santa Fe Corporation, among the largest railroads in North America, and has long owned and operated large energy companies. Some Berkshire subsidiaries are massive: eight would be included in the Fortune 500 if they were stand-alone companies. Its other interests are so vast that, as Buffett writes: "when you are looking at Berkshire, you are looking across corporate America." Examples: food, clothing, building materials, tools, equipment, newspapers, books, transportation services and financial products. Berkshire also owns large equity interests in major corporations, including American Express, Coca-Cola, International Business Machines (IBM), Procter & Gamble (through merger with longtime holdings in Gillette), The Washington Post, and Wells Fargo.

Buffett and Berkshire Vice Chairman Charlie Munger have built this sprawling enterprise by investing in businesses with excellent economic characteristics and run by outstanding managers. While they prefer negotiated acquisitions of 100% of such a business at a fair price, they take a "double-barreled approach" of buying on the open market less than 100% of some businesses when they can do so at a pro-rata price well below what it would take to buy 100%.

The double-barreled approach pays off handsomely. The value of marketable securities in Berkshire's portfolio, on a per share basis, increased from $4 in 1965 to $95,000 in 2010, a 20% compound annual increase. Per share operating earnings increased in the same period from just over $4 to nearly $6,000, a compound annual increase of about 21%. According to Buffett, these results follow not from any master plan but from focused investing—allocating capital by concentrating on businesses with outstanding economic characteristics and run by firstrate managers.

Buffett views Berkshire as a partnership among him, Munger and other shareholders, and virtually all his net worth is in Berkshire stock. His economic goal is long-term—to maximize Berkshire's per share intrinsic value by owning all or part of a diversified group of businesses that generate cash and above-average returns. In achieving this goal, Buffett foregoes expansion for the sake of expansion and foregoes divestment of businesses so long as they generate some cash and have good management.

Berkshire retains and reinvests earnings when doing so delivers at least proportional increases in per share market value over time. It uses debt sparingly and sells equity only when it receives as much in value as it gives. Buffett penetrates accounting conventions, especially those that obscure real economic earnings.

These owner-related business principles, as Buffett calls them, are the organizing themes of the accompanying essays. As organized, the essays constitute an elegant and instructive manual on management, investment, finance, and accounting. Buffett's basic principles form the framework for a rich range of positions on the wide variety of issues that exist in all aspects of business. They go far beyond mere abstract platitudes. It is true that investors should focus on fundamentals, be patient, and exercise good judgment based on common sense. In Buffett's essays, these advisory tidbits are anchored in the more concrete principles by which Buffett lives and thrives.

CORPORATE GOVERNANCE

For Buffett, managers are stewards of shareholder capital. The best managers think like owners in making business decisions. They have shareholder interests at heart. But even firstrate managers will sometimes have interests that conflict with those of shareholders. How to ease those conflicts and to nurture managerial stewardship have been constant objectives of Buffett's long career and a prominent theme of his essays. The essays address some of the most important governance problems.

The first is the importance of forthrightness and candor in communications by managers to shareholders. Buffett tells it like it is, or at least as he sees it, and laments that he is in the minority. Berkshire's annual report is not glossy; Buffett prepares its contents using words and numbers people of average intelligence can understand; and all investors get the same information at the same time. Buffett and Berkshire avoid making predictions, a bad managerial habit that too often leads other managers to make up their financial reports.

Besides the owner-orientation reflected in Buffett's disclosure practice and the owner-related business principles summarized above, the next management lesson is to dispense with formulas of managerial structure. Contrary to textbook rules on organizational behavior, mapping an abstract chain of command on to a particular business situation, according to Buffett, does little good. What matters is selecting people who are able, honest, and hard-working. Having firstrate people on the team is more important than designing hierarchies and clarifying who reports to whom about what and at what times.

Special attention must be paid to selecting a chief executive officer (CEO) because of three major differences Buffett identifies between CEOs and other employees. First, standards for measuring a CEO's performance are inadequate or easy to manipulate, so a CEO's performance is harder to measure than that of most workers. Second, no one is senior to the CEO, so no senior person's performance can be measured either. Third, a board of directors cannot serve that senior role since relations between CEOs and boards are conventionally congenial.

Major reforms are often directed toward aligning management and shareholder interests or enhancing board oversight of CEO performance. Stock options for management were touted as one method; greater emphasis on board processes was another. Separating the identities and functions of the Chairman of the Board and the CEO or appointment of standing audit, nominating and compensation committees were also heralded as promising reforms. Perhaps the most pervasive prescription is to populate boards with independent directors. None of these innovations has solved governance problems, however, and some have exacerbated them.

The best solution, Buffett instructs, is to take great care in identifying CEOs who will perform capably regardless of weak structural restraints. Large institutional shareholders must exercise their power to oust CEOs that do not measure up to the demands of corporate stewardship. Outstanding CEOs do not need a lot of coaching from owners, although they can benefit from having a similarly outstanding board. Directors therefore must be chosen for their business savvy, their interest, and their owner-orientation. According to Buffett, one of the greatest problems among boards in corporate America is that members are selected for other reasons, such as adding diversity or prominence to a board—or, famously, independence.

Most reforms are painted with a broad brush, without noting the major differences among types of board situations that Buffett identifies. For example, director power is weakest in the case where there is a controlling shareholder who is also the manager. When disagreements arise between the directors and management, there is little a director can do other than to object and, in serious circumstances, resign. Director power is strongest at the other extreme, where there is a controlling shareholder who does not participate in management. The directors can take matters directly to the controlling shareholder when disagreement arises.

The most common situation, however, is a corporation without a controlling shareholder. This is where management problems are most acute, Buffett says. It would be helpful if directors could supply necessary discipline, but board congeniality usually prevents that. To maximize board effectiveness in this situation, Buffett believes the board should be small in size and composed mostly of outside directors. The strongest weapon a director can wield in these situations remains his or her threat to resign.

All these situations do share a common characteristic: the terrible manager is a lot easier to confront or remove than the mediocre manager. A chief problem in all governance structures, Buffett emphasizes, is that in corporate America evaluation of chief executive officers is never conducted in regular meetings in the absence of that chief executive. Holding regular meetings without the chief executive to review his or her performance would be a marked improvement in corporate governance.

The CEOs at Berkshire's various operating companies enjoy a unique position in corporate America. They are given a simple set of commands: to run their business as if (1) they are its sole owner, (2) it is the only asset they hold, and (3) they can never sell or merge it for a hundred years. This enables Berkshire CEOs to manage with a long-term horizon ahead of them, something alien to the CEOs of public companies whose short-term oriented shareholders obsess with meeting the latest quarterly earnings estimate. Short-term results matter, of course, but the Berkshire approach avoids any pressure to achieve them at the expense of strengthening long-term competitive advantages.

If only short-term results mattered, many managerial decisions would be much easier, particularly those relating to businesses whose economic characteristics have eroded. Consider the time horizon trade-off Buffett faced in managing what he considers the worst investment he ever made, buying Berkshire in the first place. The economic characteristics of Berkshire's old textile business had begun to erode by the late 1970s. Buffett had hoped to devise a reversal of its misfortunes, noting how important Berkshire's textile business was to its employees and local communities in New England, and how able and understanding management and labor had been in addressing the economic difficulties. Buffett kept the ailing plant alive through 1985, but a financial reversal could not be achieved and Buffett eventually closed it. This balancing of short-term results with long-term prospects based on community trust is not easy, but it is intelligent. Kindred lessons carry over to other sectors in which Berkshire invests, such as the newspaper business in the internet age, and highly regulated industries, such as energy and railroads, in which Buffett sees an implicit social compact between private enterprise and regulatory overseers.

Sometimes management interests conflict with shareholder interests in subtle or easily disguised ways. Take corporate philanthropy, for example. At most major corporations, management allocates a portion of corporate profit to charitable concerns. The charities are chosen by management, for reasons often unrelated either to corporate interests or shareholder interests. Most state laws permit management to make these decisions, so long as aggregate annual donations are reasonable in amount, usually not greater than 10% of annual net profits.

Berkshire does things differently. It makes no contributions at the parent company level and allows its subsidiaries to follow philanthropic policies they had in effect before Berkshire acquired them. For two decades, moreover, Berkshire used an imaginative program through which its shareholders designated the charities to which Berkshire would donate and in what amounts. Nearly all shareholders participated, donating tens of millions of dollars annually to thousands of different charities. Political controversy over the abortion issue, however, interfered with this program. Political activists organized boycotts of Berkshire's products to protest particular charitable donations that were made, destroying this feature of Berkshire's "partnership" approach.

The plan to align management and shareholder interests by awarding executives stock options not only was oversold, but also subtly disguised a deeper division between those interests that the options created. Many corporations pay their managers stock options whose value increases simply by retention of earnings, rather than by superior deployment of capital. As Buffett explains, however, simply by retaining and reinvesting earnings, managers can report annual earnings increases without so much as lifting a finger to improve real returns on capital. Stock options thus often rob shareholders of wealth and allocate the booty to executives. Moreover, once granted, stock options are often irrevocable, unconditional, and benefit managers without regard to individual performance.

It is possible to use stock options to instill a managerial culture that encourages owner-like thinking, Buffett agrees. But the alignment will not be perfect. Shareholders are exposed to the downside risks of suboptimal capital deployment in a way that an option holder is not. Buffett therefore cautions shareholders who are reading proxy statements about approving option plans to be aware of the asymmetry in this kind of alignment. Many shareholders rationally ignore proxy statements, but the abuse of stock options should be on the front-burner of shareholders, particularly institutional investors that periodically engage in promoting corporate governance improvements.

Buffett emphasizes that performance should be the basis for executive pay decisions. Executive performance should be measured by profitability, after profits are reduced by a charge for the capital employed in the relevant business or earnings retained by it. If stock options are used, they should be related to individual performance, rather than corporate performance, and priced based on business value. Better yet, as at Berkshire, stock options should simply not be part of an executive's compensation. After all, exceptional managers who earn cash bonuses based on the performance of their own business can simply buy stock if they want to; if they do, they "truly walk in the shoes of owners," Buffett says. And owners' interests are paramount on executive pay as with other corporate governance topics Buffett addresses, such as risk management, corporate compliance and financial reporting.

Finance and Investing

The most revolutionary investing ideas of the past thirty-five years were those called modern finance theory. This is an elaborate set of ideas that boil down to one simple and misleading practical implication: it is a waste of time to study individual investment opportunities in public securities. According to this view, you will do better by randomly selecting a group of stocks for a portfolio by throwing darts at the stock tables than by thinking about whether individual investment opportunities make sense.

One of modern finance theory's main tenets is modern portfolio theory. It says that you can eliminate the peculiar risk of any security by holding a diversified portfolio—that is, it formalizes the folk slogan "don't put all your eggs in one basket." The risk that is left over is the only risk for which investors will be compensated, the story goes.

This leftover risk can be measured by a simple mathematical term—called beta—that shows how volatile the security is compared to the market. Beta measures this volatility risk well for securities that trade on efficient markets, where information about publicly traded securities is swiftly and accurately incorporated into prices. In the modern finance story, efficient markets rule.

Reverence for these ideas was not limited to ivory tower academics, in colleges, universities, business schools, and law schools, but became standard dogma throughout financial America in the past thirty-five years, from Wall Street to Main Street. Many professionals still believe that stock market prices always accurately reflect fundamental values, that the only risk that matters is the volatility of prices, and that the best way to manage that risk is to invest in a diversified group of stocks.

Being part of a distinguished line of investors stretching back to Graham and Dodd which debunks standard dogma by logic and experience, Buffett thinks most markets are not purely efficient and that equating volatility with risk is a gross distortion. Accordingly, Buffett worried that a whole generation of MBAs and JDs, under the influence of modern finance theory, was at risk of learning the wrong lessons and missing the important ones.

A particularly costly lesson of modern finance theory came from the proliferation of portfolio insurance—a computerized technique for readjusting a portfolio in declining markets. The promiscuous use of portfolio insurance helped precipitate the stock market crash of October 1987, as well as the market break of October 1989. It nevertheless had a silver lining: it shattered the modern finance story being told in business and law schools and faithfully being followed by many on Wall Street.

Ensuing market volatility could not be explained by modern finance theory, nor could mountainous other phenomena relating to the behavior of small capitalization stocks, high dividend-yield stocks, and stocks with low price-earnings ratios. The *piece de resistance* of market inefficiency was the technology and Internet stock bubble that blew up in the late 1990s and early 2000s, marked by stock price gyrations that spasmodically bounced between euphoria and gloom without the remotest nexus to business value. Growing numbers of skeptics emerged to say that beta does not really measure the investment risk that matters, and that capital markets are really not efficient enough to make beta meaningful anyway.

In stirring up the discussion, people started noticing Buffett's record of successful investing and calling for a return to the Graham-Dodd approach to investing and business. After all, for more than forty years Buffett has generated average annual returns of 20% or better, which double the market average. For more than twenty years before that, Ben Graham's Graham-Newman Corp. had done the same thing. As Buffett emphasizes, the stunning performances at Graham-Newman and at Berkshire deserve respect: the sample sizes were significant; they were conducted over an extensive time period, and were not skewed by a few fortunate experiences; no data-mining was involved; and the performances were longitudinal, not selected by hindsight.

Threatened by Buffett's performance, stubborn devotees of modern finance theory resorted to strange explanations for his success. Maybe he is just lucky—the monkey who typed out *Hamlet*—or maybe he has inside access to information that other investors do not. In dismissing Buffett, modern finance enthusiasts still insist that an investor's best strategy is to diversify based on betas or dart throwing, and constantly reconfigure one's portfolio of investments.

Buffett responds with a quip and some advice: the quip is that devotees of his investment philosophy should probably endow chaired professorships at colleges and universities to ensure the perpetual teaching of efficient market dogma; the advice is to ignore modern finance theory and other quasi-sophisticated views of the market and stick to investment knitting. That can best be done for many people through long-term investment in an index fund. Or it can be done by conducting hard-headed analyses of businesses within an investor's competence to evaluate. In that kind of thinking, the risk that matters is not beta or volatility, but the possibility of loss or injury from an investment.

Assessing that kind of investment risk requires thinking about a company's management, products, competitors, and debt levels. The inquiry is whether after-tax returns on an investment are at least equal to the purchasing power of the initial investment plus a fair rate of return. The primary relevant factors are the long-term economic characteristics of a business, the quality and integrity of its management, and future levels of taxation and inflation. Maybe these factors are vague, particularly compared with the seductive precision of beta, but the point is that judgments about such matters cannot be avoided, except to an investor's disadvantage.

Buffett points out the absurdity of beta by observing that "a stock that has dropped very sharply compared to the market . . . becomes 'riskier' at the lower price than it was at the higher price"—that is how beta measures risk. Equally unhelpful, beta cannot distinguish the risk inherent in "a single-product toy company selling pet rocks or hula hoops from another toy company whose sole product is Monopoly or Barbie." But ordinary investors can make those distinctions by thinking about consumer behavior and the way consumer products companies compete, and can also figure out when a huge stock-price drop signals a buying opportunity.

Contrary to modern finance theory, Buffett's investment knitting does not prescribe diversification. It may even call for concentration, if not of one's portfolio, then at least of its owner's mind. As to concentration of the portfolio, Buffett reminds us that Keynes, who was not only a brilliant economist but also an astute investor, believed that an investor should put fairly large sums into two or three businesses he knows something about and whose management is trustworthy. On that view, risk rises when investments and investment thinking are spread too thin. A strategy of financial and mental concentration may reduce risk by raising both the intensity of an investor's thinking about a business and the comfort level he must have with its fundamental characteristics before buying it.

The fashion of beta, according to Buffett, suffers from inattention to "a fundamental principle: It is better to be approximately right than precisely wrong." Long-term investment success depends not on studying betas and maintaining a diversified portfolio, but on recognizing that as an investor, one is the owner of a business. Reconfiguring a portfolio by buying and selling stocks to accommodate the desired beta-risk profile defeats long-term investment success. Such "flitting from flower to flower" imposes huge transaction costs in the forms of spreads, fees and commissions, not to mention taxes. Buffett jokes that calling someone who trades actively in the market an investor "is like calling someone who repeatedly engages in one-night stands a romantic." Investment knitting turns modern finance theory's folk wisdom on its head: instead of "don't put all your eggs in one basket," we get Mark Twain's advice from *Pudd'nhead Wilson*: "Put all your eggs in one basket—and watch that basket."

Buffett learned the art of investing from Ben Graham as a graduate student at Columbia Business School in the 1950s and later working at Graham-Newman. In a number of classic works, including *The Intelligent Investor*, Graham introduced some of the most profound investment wisdom in history. It rejects a prevalent but mistaken mind-set that equates price with value. On the contrary, Graham held that price is what you pay and value is what you get. These two things are rarely identical, but most people rarely notice any difference.

One of Graham's most profound contributions is a character who lives on Wall Street, Mr. Market. He is your hypothetical business partner who is daily willing to buy your interest in a business or sell you his at prevailing market prices. Mr. Market is moody, prone to manic swings from joy to despair. Sometimes he offers prices way higher than value; sometimes he offers prices way lower than value. The more manic-depressive he is, the greater the spread between price and value, and therefore the greater the investment opportunities he offers. Buffett reintroduces Mr. Market, emphasizing how valuable Graham's allegory of the overall market is for disciplined investment knitting—even though Mr. Market would be unrecognizable to modern finance theorists.

Another leading prudential legacy from Graham is his margin-of-safety principle. This principle holds that one should not make an investment in a security unless there is a sufficient basis for believing that the price being paid is substantially lower than the value being delivered. Buffett follows the principle devotedly, noting that Graham had said that if forced to distill the secret of sound investment into three words, they would be: margin of safety. Over forty years after first reading that, Buffett still thinks those are the right words. While modern finance theory enthusiasts cite market efficiency to deny there is a difference between price (what you pay) and value (what you get), Buffett and Graham regard it as all the difference in the world.

That difference also shows that the term "value investing" is a redundancy. All true investing must be based on an assessment of the relationship between price and value. Strategies that do not employ this comparison of price and value do not amount to investing at all, but to speculation—the hope that price will rise, rather than the conviction that the price being paid is lower than the value being obtained. Many professionals make another common mistake, Buffett notes, by distinguishing between "growth investing" and "value investing."

Growth and value, Buffett says, are not distinct. They are integrally linked since growth must be treated as a component of value.

Nor does the phrase “relational investing” resonate with Buffett. The term became popular in the mid-1990s, describing a style of investing that is designed to reduce the costs of the separation of shareholder ownership from managerial control by emphasizing shareholder involvement and monitoring of management. Many people incorrectly identified Buffett and Berkshire as exemplars of this descriptive label. It is true that Buffett buys big blocks in a few companies and sticks around a long time. He also only invests in businesses run by people he trusts. But that is about as far as the similarity goes. If Buffett were pressed to use an adjective to describe his investment style, it would be something like “focused” or “intelligent” investing. Yet even these words ring redundant; the unadorned term *investor* best describes Buffett.

Other misuses of terms include blurring the difference between speculation and arbitrage as methods of sound cash management; the latter being very important for companies like Berkshire that generate substantial excess cash. Both speculation and arbitrage are ways to use excess cash rather than hold it in short-term cash equivalents such as commercial paper. Speculation describes the use of cash to bet on lots of corporate events based on rumors of unannounced coming transactions. Arbitrage, traditionally understood to mean exploiting different prices for the same thing on two different markets, for Buffett describes the use of cash to take short-term positions in a few opportunities that have been publicly announced. It exploits different prices for the same thing at different times. Deciding whether to employ cash this way requires evaluating four commonsense questions based on information rather than rumor: the probability of the event occurring, the time the funds will be tied up, the opportunity cost, and the downside if the event does not occur.

The circle of competence principle is the third leg of the Graham/Buffett stool of intelligent investing, along with Mr. Market and the margin of safety. This commonsense rule instructs investors to consider investments only concerning businesses they are capable of understanding with a modicum of effort. It is this commitment to stick with what he knows that enables Buffett to avoid the mistakes others repeatedly make, particularly those who feast on the fantasies of fast riches promised by technological fads and new era rhetoric that have recurrently infested speculative markets over the centuries.

In all investment thinking, one must guard against what Buffett calls the “institutional imperative.” It is a pervasive force in which institutional dynamics produce resistance to change, absorption of available corporate funds, and reflexive approval of suboptimal CEO strategies by subordinates. Contrary to what is often taught in business and law schools, this powerful force often interferes with rational business decision-making. The ultimate result of the institutional imperative is a follow-the-pack mentality producing industry imitators, rather than industry leaders—what Buffett calls a lemming-like approach to business.

Every reader of this collection will savor, and want to share with family and friends, Buffett's compelling essays on the use of debt. Aptly dubbed "Life and Debt," these exquisitely explain both the temptation and perils of leverage in personal and corporate finance.

INVESTMENT ALTERNATIVES

All these investment principles are animated in Buffett's lively essays concerning investment opportunities. After explaining his preference for investing in productive assets, and defining what this means, a series of essays addresses a wide range of alternatives, starting with junk and zero-coupon bonds and preferred stock. Challenging both Wall Street and the academy, Buffett again draws on Graham's ideas to reject the "dagger thesis" advanced to defend junk bonds. The dagger thesis, using the metaphor of the intensified care an automobile driver would take facing a dagger mounted on the steering wheel, overemphasizes the disciplining effect that enormous amounts of debt in a capital structure exerts on management.

Buffett points to the large numbers of corporations that failed in the early 1990s recession under crushing debt burdens to dispute academic research showing that higher interest rates on junk bonds more than compensated for their higher default rates. He attributes this error to a flawed assumption recognizable to any first-year statistics student: that historical conditions prevalent during the study period would be identical in the future. They would not. Further illuminating the folly of junk bonds is an essay in this collection by Charlie Munger that discusses Michael Milken's approach to finance.

Wall Street tends to embrace ideas based on revenue-generating power, rather than on financial sense, a tendency that often perverts good ideas to bad ones. In a history of zero-coupon bonds, for example, Buffett shows that they can enable a purchaser to lock in a compound rate of return equal to a coupon rate that a normal bond paying periodic interest would not provide. Using zero-coupons thus for a time enabled a borrower to borrow more without need of additional free cash flow to pay the interest expense. Problems arose, however, when zero-coupon bonds started to be issued by weaker and weaker credits whose free cash flow could not sustain increasing debt obligations. Buffett laments, "as happens in Wall Street all too often, what the wise do in the beginning, fools do in the end."

Many culprits contributed to the financial crisis of 2008, among them the proliferation of derivative financial instruments, which Buffett's essays written several years earlier had warned about. Contemporary financial engineering has produced an explosion of complex instruments known as derivatives, because their fluctuating value is *derived* from movements in a contractually designated benchmark. Proponents believe that these devices are useful to manage risk—and Berkshire from time to time takes modest positions in derivatives contracts that Buffett judges as mis-priced. But while proponents also believe that derivatives tend to reduce overall *systemic* risk, Buffett presciently observed that they may have the opposite effect. They are hard to value, valuations can change rapidly and they create linkages and interdependencies among financial institutions. Buffett cautioned that the combination of these factors could mean that, should a single event cause challenges in one sector, that could spread rapidly to others with a domino effect bringing devastating systemic consequences. Such was the case with the crisis of 2008.

Buffett acknowledges that his view on derivative risks may be influenced by his aversion to any kind of mega-catastrophe risk that would jeopardize Berkshire's status as a fortress of financial strength. But this is no arm-chair opinion, for Buffett endured several years of direct experience in managing a derivatives dealership that came along with Berkshire's acquisition of the Gen Re reinsurance company. Buffett explains the unpleasant consequences of not dumping the business immediately but notes how it could not be sold and contained a maze of long term liabilities that took several painful years to unwind. Buffett offers extensive meditation on this experience so that others can learn from the Berkshire trials.

Concluding essays in this Part address other macroeconomic lessons as well, ranging from the U.S. international trade deficit to national policies towards home ownership that also contributed to the financial crisis of 2008.

COMMON STOCK

Buffett recalls that on the day Berkshire listed on the New York Stock Exchange in 1988, he told Jimmy Maguire, the specialist in Berkshire stock, "I will consider you an enormous success if the next trade in this stock is about two years from now." While Buffett jokes that Maguire "didn't seem to get enthused about that," he emphasizes that his mind-set when he buys any stock is "if we aren't happy owning a piece of that business with the Exchange closed, we're not happy owning it with the Exchange open." While Berkshire and Buffett are investors for the long haul, too many others are temporary traders of common stock—whose actions pose high costs.

A significant portion of corporate earnings are dissipated through frictional costs associated with trading. Trading is the rearrangement of who owns what shares. The rearrangement entails paying commissions to brokers, fees to investment managers and cash to financial planners and business consultants who sell even more advice during this process. Of late, these frictional costs have escalated into whole industries that describe themselves variously as hedge funds and private equity firms. Buffett estimates that total costs may consume some 20% of the country's total annual corporate earnings.

Unlike many CEOs, who desire their company's stock to trade at the highest possible prices in the market, Buffett prefers Berkshire stock to trade at or around its intrinsic value—neither materially higher nor lower. Such linkage means that business results during one period will benefit the people who owned the company during that period. Maintaining the linkage requires a shareholder group with a collective long-term, business-oriented investment philosophy, rather than a short-term, market-oriented strategy.

Buffett notes Phil Fisher's suggestion that a company is like a restaurant, offering a menu that attracts people with particular tastes. Berkshire's long-term menu emphasizes that the costs of trading activity can impair long-term results. Indeed, Buffett estimates that the transaction costs of actively traded stocks—broker commissions and market-maker spreads—often amount to 10% or more of earnings. Avoiding or minimizing such costs is necessary for long-term investment success, and Berkshire's listing on the New York Stock Exchange helped contain those costs.

Corporate dividend policy is a major capital allocation issue, always of interest to investors but infrequently explained to them. Buffett's essays clarify this subject, emphasizing that "capital allocation is crucial to business and investment management." Since 1998, Berkshire's common stock has been priced in the market at above $50,000 per share and the company's book value, earnings, and intrinsic value have steadily increased well in excess of average annual rates. Yet the company has never effected a stock split, and has not paid a cash dividend in over three decades.

Apart from reflecting the long-term menu and minimization of transaction costs, Berkshire's dividend policy also reflects Buffett's conviction that a company's earnings payout versus retention decision should be based on a single test: each dollar of earnings should be retained if retention will increase market value by at least a like amount; otherwise it should be paid out. Earnings retention is justified only when "capital retained produces incremental earnings equal to, or above, those generally available to investors."

Like many of Buffett's simple rules, this one is often ignored by corporate managers, except of course when they make dividend decisions for their subsidiaries. Earnings are often retained for non-owner reasons, such as expanding the corporate empire or furnishing operational comfort for management.

Things are so different at Berkshire, Buffett said at the symposium, that under his test Berkshire "might distribute more than 100% of the earnings," to which Charlie Munger chimed in "You're damn right." That has not been necessary, however, for throughout Buffett's stewardship at Berkshire, opportunities for superior returns on capital have been discovered, and exploited.

Share repurchases of underpriced stock can be a value-enhancing way to allocate capital, though these are not always what they seem. In the 1980s and early 1990s, share buy-backs were uncommon and Buffett credited managers who recognized that the purchase of a share priced at $1 but with a value of $2 would rarely be inferior to any other use of corporate funds. Alas, as often happens, the imitators stepped in and now you frequently see companies paying $2 to buy back shares worth $1. These value-destroying share repurchases often are intended to prop up a sagging share price or to offset the simultaneous issuing of stock under stock options exercised at much lower prices.

Buffett lays out the rationale and terms under which Berkshire occasionally embarks on share repurchase programs: when the stock trades at a deep discount to intrinsic value. That makes the investment an easy case, of clear value to continuing holders, though Buffett has mixed feelings about repurchasing as Berkshire's selling shareholders cash in at a discount. The solution: clear disclosure to enable such selling holders to make an informed decision.

Stock splits are another common action in corporate America that Buffett points out disserve owner interests. Stock splits have three consequences: they increase transaction costs by promoting high share turnover; they attract shareholders with short-term, market-oriented views who unduly focus on stock market prices; and, as a result of both of those effects, they lead to prices that depart materially from intrinsic business value. With no offsetting benefits, splitting Berkshire's stock would be foolish. Not only that, Buffett adds, it would threaten to reverse over three decades of hard work that has attracted to Berkshire a shareholder group comprised of more focused and long-term investors than probably any other major public corporation.

Two important consequences have followed from Berkshire's high stock price and its dividend policy. First, the extraordinarily high share price impaired the ability of Berkshire shareholders to effect gifts of their equity interest to family members or friends, though Buffett has offered a few sensible strategies like bargain sales to donees to deal with that. Second, Wall Street engineers tried to create securities that would purport to mimic Berkshire's performance and that would be sold to people lacking an understanding of Berkshire, its business, and its investment philosophy.

In response to these consequences, Berkshire effected a recapitalization by creating a new class of stock, called the Class B shares, and sold it to the public. The Class B shares have 1/30th the rights of the existing Class A shares, except with respect to voting rights they have 1/200th of those of the A shares. Accordingly, the Class B shares should (and do) trade somewhere in the vicinity of 1/30th of the market price of the Class A shares.

The Class A shares are convertible into Class B shares, giving Berkshire shareholders a do-it-yourself mechanism to effect a stock-split to facilitate gift giving and so on. More importantly, the Berkshire recapitalization would halt the marketing of Berkshire clones that contradict all the basic principles Buffett believes in. These clones—investment trusts that would buy and sell Berkshire shares according to demand for units in the trust—would have imposed costs on shareholders. If held by people who do not understand Berkshire's business or philosophy, they would have caused spikes in Berkshire's stock price, producing substantial deviations between price and value.

The Class B shares are designed to be attractive only to investors who share Buffett's philosophy of focused investing. For example, in connection with the offering of the Class B shares, Buffett and Munger emphasized that Berkshire stock was, at that time, not underpriced in the market. They said that neither of them would buy the Class A shares at the market price nor the Class B shares at the offering price. The message was simple: do not buy these securities unless you are prepared to hold them for the long term. The effort to attract only long-term investors to the Class B shares appears to have worked: trading volume in the shares after the offering was far below average for Big Board stocks.

Some expressed surprise at Buffett and Munger's cautionary statement, since most managers tell the market that newly-issued equity in their companies is being offered at a very good price. You should not be surprised by Buffett and Munger's disclosure, however. A company that sells its stock at a price less than its value is stealing from its existing shareholders. Quite plausibly, Buffett considers that a crime.

MERGERS AND ACQUISITIONS

Berkshire's acquisition policy is the double-barreled approach: buying portions or all of businesses with excellent economic characteristics and run by managers Buffett and Munger like, trust, and admire. Contrary to common practice, Buffett argues that in buying all of a business, there is rarely any reason to pay a premium.

The rare cases involve businesses with franchise characteristics—those that can raise prices without impairing sales volume or market share and only require incremental capital investment to increase both. Even ordinary managers can operate franchise businesses to generate high returns on capital. The second category of rare cases is where extraordinary managers exist who can achieve the difficult feat of identifying underperforming businesses, and apply extraordinary talent to unlock hidden value.

These two categories are extremely limited, and certainly do not explain the hundreds of high-premium takeovers that occur annually. Buffett attributes high-premium takeovers outside those unusual categories to three motives of buying-managers: the thrill of an acquisition, the thrill of enhanced size, and excessive optimism about synergies.

In paying for acquisitions, Berkshire issues stock only when it receives as much in business value as it gives. This has become increasingly difficult for Berkshire to do. This is the case because Berkshire has assembled the business equivalent of the art collection at the Louvre. Enhancing the value of the existing collection by adding a single new Botticelli is difficult enough, and even more so if you have to give up part of your Rembrandt collection to get it.

It has also been difficult for managers of other companies to follow this rule, but not so much because of the wonderful collection of businesses they have. Instead, Buffett notes that sellers in stock acquisitions measure the purchase price by the market price of the buyer's stock, not by its intrinsic value. If a buyer's stock is trading at a price equal to, say, half its intrinsic value, then a buyer who goes along with that measure gives twice as much in business value as it is getting. Its manager, usually rationalizing his or her actions by arguments about synergies or size, is elevating thrill or excessive optimism above shareholder interests.

Moreover, acquisitions paid for in stock are too often (almost always) described as "buyer buys seller" or "buyer acquires seller." Buffett suggests clearer thinking would follow from saying "buyer sells part of itself to acquire seller," or something of the sort. After all, that is what is happening; and it would enable one to evaluate what the buyer is giving up to make the acquisition.

Another abuse of shares-as-currency is the practice of green-mail, the repurchase of shares from an unwanted suitor at a premium price to fend off his acquisition overtures. While share repurchases available to all shareholders can be value enhancing, Buffett condemns this practice as simply another form of corporate robbery.

Nearly as reprehensible, a second Charlie Munger essay in this collection explains, were the cascades of leveraged buy-outs (LBOs) in the 1980s. Permissive laws made LBOs hugely profitable, Munger tells us, but the LBOs weakened corporations, put a heavy premium on cash generation to pay for enormous debt obligations, and raised the average cost of acquisitions.

Value-enhancing acquisitions are hard enough to find without the added burden of higher average costs for all of them. Indeed, most acquisitions are value-decreasing, Buffett says. Finding the best value-enhancing transactions requires concentrating on opportunity costs, measured principally against the alternative of buying small pieces of excellent businesses through stock market purchases. Such concentration is alien to the manager obsessed with synergies and size, but a vital part of Berkshire's double-barreled investment approach.

Berkshire has additional advantages in acquisitions: a high quality stock to pay with and a substantial amount of managerial autonomy to offer once a deal is done—both rare in an acquiring company, Buffett says. Buffett also puts his money where his mouth is, reminding prospective sellers that Berkshire has acquired many of its businesses from family or other closely-held groups, and inviting them to check with every previous seller about Berkshire's initial promises measured against its later actions. In short, Berkshire seeks to be the buyer of choice for attractive business sellers—a lesson so important that it explains why Buffett prefers to retain rather than sell even those acquired businesses that struggle against business headwinds.

Valuation and Accounting

Buffett's essays provide an entertaining and illuminating tutorial on understanding and using financial information. In dissecting significant aspects of generally accepted accounting principles (GAAP), Buffett shows both their importance and limits in understanding and valuing any business or investment. Buffett demystifies key topics that highlight the important differences between accounting earnings and economic earnings, between accounting goodwill and economic goodwill, and between accounting book value and intrinsic value. These are essential tools for any investor's or manager's valuation toolbox.

Aesop was to fables of the ancient world what Buffett is to business essays in ours. The essayist invokes the fabulist to show that valuation has been the same across the millennia—Aesop said "a bird in the hand is worth two in the bush” and Buffett extends the principle to dollars. Valuation is counting cash, not hopes or dreams, a lesson many should have learned amid the late 1990s tech rush bubble that burst when everyone finally realized there were few birds in the bushes. It is doubtful everyone learned the lesson, however, for it has been taught repeatedly since Aesop’s time and yet, well, it has been taught repeatedly since Aesop’s time.

A leading example of Buffett’s specialized toolkit is intrinsic value, “the discounted value of the cash that can be taken out of a business during its remaining life.” Though simple to state, calculating intrinsic value is neither easy nor objective. It depends on estimation of both future cash flows and interest rate movements. But it is what ultimately matters about a business. Book value, in contrast, is easy to calculate, but of limited use. So too with market price, at least for most companies. Differences between intrinsic value and book value and market price may be hard to pin down. They can go either way, but there will almost certainly be differences.

Buffett emphasizes that useful financial statements must enable a user to answer three basic questions about a business: approximately how much a company is worth, its likely ability to meet its future obligations, and how good a job its managers are doing in operating the business. Buffett laments that GAAP conventions make these determinations difficult, and indeed almost any accounting system will be hard pressed to furnish completely accurate answers given the complexities of business. Acknowledging the monumental difficulty of inventing an accounting system superior to GAAP, Buffett articulates a range of concepts that go a longer way toward making financial information useful to investors and managers.

Consider a concept Buffett calls “look-through earnings.” GAAP investment accounting calls for using the consolidation method for majority-owned equity, which means full reporting of all line items from the investee’s financial statements on the parent’s. For equity investments from 20% to 50%, GAAP calls for reporting the investor’s proportionate share of earnings of the investee on its statements; for investments of less than 20%, GAAP provides that only dividends actually received by the investor be recorded, rather than any share of the investee’s earnings. These accounting rules obscure a major factor in Berkshire’s economic performance: the undistributed earnings of its investee companies are an enormous part of Berkshire’s value, but would not be reported on its financial statements prepared using GAAP.

Recognizing that it is not the size of an equity investment that determines its value, but how the undistributed earnings are deployed, Buffett develops the concept of look-through earnings to gauge Berkshire’s economic performance.

Look-through earnings add to Berkshire's own net earnings the undistributed earnings in investee companies, less an incremental amount for taxes. Look-through earnings are not different from GAAP earnings for many businesses. But they are for Berkshire and probably are for many individual investors. Accordingly, individuals can adopt a similar approach for their own portfolios and try to design a portfolio that delivers the highest possible look-through earnings over the long term.

The difference between accounting goodwill and economic goodwill is well-known, but Buffett's lucidity makes the subject refreshing. Accounting goodwill is essentially the amount by which the purchase price of a business exceeds the fair value of the assets acquired (after deducting liabilities). It is recorded as an asset on the balance sheet and then amortized as an annual expense, usually over forty years. So the accounting goodwill assigned to that business decreases over time by the aggregate amount of that expense.

Economic goodwill is something else. It is the combination of intangible assets, like brand name recognition, that enable a business to produce earnings on tangible assets, like plant and equipment, in excess of average rates. The amount of economic goodwill is the capitalized value of that excess. Economic goodwill tends to increase over time, at least nominally in proportion to inflation for mediocre businesses, and more than that for businesses with solid economic or franchise characteristics. Indeed, businesses with more economic goodwill relative to tangible assets are hurt far less by inflation than businesses with less of that.

These differences between accounting goodwill and economic goodwill entail the following insights. First, the best guide to the value of a business's economic goodwill is what it can earn on unleveraged net tangible assets, excluding charges for amortization of goodwill. Therefore when a business acquires other businesses, and the acquisitions are reflected in an asset account called goodwill, analysis of that business should ignore the amortization charges. Second, since economic goodwill should be measured at its full economic cost, i.e., before amortization, evaluation of a possible business acquisition should be conducted without regard to those amortization charges as well.

Buffett emphasizes, however, that the same does not hold for depreciation charges—these should not be ignored because they are real economic costs. He makes this point in explaining why Berkshire always shows its shareholders the results of operations with respect to acquired businesses net of any purchase price adjustments GAAP requires.

It is common on Wall Street to value businesses using a calculation of cash flows equal to (*a*) operating earnings plus (*b*) depreciation expense and other non-cash charges. Buffett regards that calculation as incomplete. After taking (*a*) operating earnings and adding back (*b*) non-cash charges, Buffett argues that you must then subtract something else: (*c*) required reinvestment in the business. Buffett defines (*c*) as "the average amount of capitalized expenditures for plant and equipment, etc., that the business requires to fully maintain its long-term competitive position and its unit volume." Buffett calls the result of (*a*) + (*b*) - (*c*) "owner earnings."

When (*b*) and (*c*) differ, cash flow analysis and owner earnings analysis differ too. For most businesses, (*c*) usually exceeds (*b*), so cash flow analysis usually overstates economic reality. In all cases where (*c*) differs from (*b*), calculation of owner earnings enables one to appraise performance more accurately than would analysis of GAAP earnings, or cash flows affected by purchase price accounting adjustments. That is why Berkshire supplementally reports owner earnings for its acquired businesses, rather than rely solely on GAAP earnings figures, or cash flow figures.

Accounting Shenanigans

The ultimate point to understand about accounting is that it is a form. As a form, it can be manipulated. Buffett shows just how severe the manipulation can be with a satire written by Ben Graham in the 1930s. The advanced bookkeeping methods Graham presents enable his phantom US Steel to report "phenomenally enhanced" earnings without cash outlays or changes in operating conditions or sales. Except in its lampooning spirit, Graham's illustration of accounting chicanery is not all that different from what is often seen coming out of corporate America.

GAAP has enough trouble. Yet two groups of people make it worse: those who try to overcome GAAP requirements by stretching their accounting imagination, and those who deliberately employ GAAP to facilitate financial fraud. The former is especially hard to deal with, as Buffett suggests in illustrating how debate on accounting for stock options reveals the parochialism of many executives and accountants. For example, criticizing the view against treating stock options as expenses when granted, Buffett delivers this laconic argument: "If options aren't a form of compensation, what are they? If compensation isn't an expense, what is? And, if expenses shouldn't go into the calculation of earnings, where in the world should they go?" So far, he has gotten no answers.

The quest for integrity in financial reporting is endless, with new flavors of accounting machinations developed regularly and periodically sweeping the chief financial officer (CFO) suites of corporate America. The latest product to catch on is accounting for “restructurings,” a label given to a whole range of maneuvers that enable managers to engage in age-old earnings management and smoothing techniques with greater felicity and deftness than ever before. Other examples concern estimates required when calculating pension liabilities and the timing of sales of assets that generate gains or losses to influence reported earnings. Investors beware.

ACCOUNTING POLICY

Devotees of integrity in financial reporting sometimes must take matters into their own hands. Buffett does so regularly by furnishing Berkshire shareholders with information, such as segment data, that GAAP does not require but which Buffett would want to see if their positions were reversed. Sometimes the crusaders triumph, however, as Buffett shows was the case when accounting rules began to require companies to record promises to fund retiree benefits that had previously not been required.

One clear lesson from Buffett’s discussions of financial information is that accounting has inherent limits, even though it is absolutely essential. Despite enormous managerial leeway in reporting earnings and potential abuse, financial information can be of great use to investors. Buffett uses it every day, and has allocated billions of dollars doing it. So it is possible to make important investment decisions on the basis of available financial information if one exercises knowledgeable judgment. That judgment may include making adjustments to determine look-through earnings, owner earnings and intrinsic value.

TAX MATTERS

Bringing this collection full circle, the concluding essays note the obvious but often overlooked tax advantages of long-term investment. Linking life’s two certainties, the final essay includes one of Buffett’s many jokes about his personal longevity: if enjoying life promotes longevity, he is jeopardizing Methuselah’s record (969 years). At the symposium featuring this collection, someone asked what effect Buffett’s death would have on Berkshire stock. Another answered, “a negative effect.” Without missing a beat, Buffett quipped: “It won’t be as negative for the holders as it will be for me.”

PROLOGUE: OWNER-RELATED BUSINESS PRINCIPLES[1]

In some ways, our shareholder group is a rather unusual one, and this affects our manner of reporting to you. For example, at the end of each year about 98% of the shares outstanding are held by people who also were shareholders at the beginning of the year. Therefore, in our annual report we build upon what we have told you in previous years instead of restating a lot of material. You get more useful information this way, and we don’t get bored.

Furthermore, perhaps 90% of our shares are owned by investors for whom Berkshire is their largest security holding, very often far and away the largest. Many of these owners are willing to spend a significant amount of time with the annual report, and we attempt to provide them with the same information we would find useful if the roles were reversed.

In contrast, we include no narrative with our quarterly reports. Our owners and managers both have very long time-horizons in regard to this business, and it is difficult to say anything new or meaningful each quarter about events of long-term significance.

But when you do receive a communication from us, it will come from the fellow you are paying to run the business. Your Chairman has a firm belief that owners are entitled to hear directly from the CEO as to what is going on and how he evaluates the business, currently and prospectively. You would demand that in a private company; you should expect no less in a public company. A once-a-year report of stewardship should not be turned over to a staff specialist or public relations consultant who is unlikely to be in a position to talk frankly on a manager-to-owner basis.

We feel that you, as owners, are entitled to the same sort of reporting by your managers as we feel is owed to us at Berkshire Hathaway by managers of our business units. Obviously, the degree of detail must be different, particularly where information would be useful to a business competitor or the like. But the general scope, balance, and level of candor should be similar. We don’t expect a public relations document when our operating managers tell us what is going on, and we don’t feel you should receive such a document.

In large part, companies obtain the shareholder constituency that they seek and deserve. If they focus their thinking and communications on short-term results or short-term stock market consequences they will, in large part, attract shareholders who focus on the same factors. And if they are cynical in their treatment of investors, eventually that cynicism is highly likely to be returned by the investment community.

Phil Fisher, a respected investor and author, once likened the policies of the corporation in attracting shareholders to those of a restaurant attracting potential customers. A restaurant could seek a given clientele—patrons of fast foods, elegant dining, Oriental food, etc.—and eventually obtain an appropriate group of devotees. If the job were expertly done, that clientele, pleased with the service, menu, and price level offered, would return consistently. But the restaurant could not change its character constantly and end up with a happy and stable clientele. If the business vacillated between French cuisine and take-out chicken, the result would be a revolving door of confused and dissatisfied customers.

So it is with corporations and the shareholder constituency they seek. You can't be all things to all men, simultaneously seeking different owners whose primary interests run from high current yield to long-term capital growth to stock market pyrotechnics, *etc.*

The reasoning of managements that seek large trading activity in their shares puzzles us. In effect, such managements are saying that they want a good many of the existing clientele continually to desert them in favor of new ones—because you can't add lots of new owners (with new expectations) without losing lots of former owners.

We much prefer owners who like our service and menu and who return year after year. It would be hard to find a better group to sit in the Berkshire Hathaway shareholder "seats" than those already occupying them. So we hope to continue to have a very low turnover among our owners, reflecting a constituency that understands our operation, approves of our policies, and shares our expectations. And we hope to deliver on those expectations.

1. *Although our form is corporate, our attitude is partnership. Charlie Munger and I think of our shareholders as owner-partners, and of ourselves as managing partners. (Because of the size of our shareholdings we are also, for better or worse, controlling partners.) We do not view the company itself as the ultimate owner of our business assets but instead view the company as a conduit through which our shareholders own the assets.*

Charlie and I hope that you do not think of yourself as merely owning a piece of paper whose price wiggles around daily and that is a candidate for sale when some economic or political event makes you nervous. We hope you instead visualize yourself as a part owner of a business that you expect to stay with indefinitely, much as you might if you owned a farm or apartment house in partnership with members of your family. For our part, we do not view Berkshire shareholders as faceless members of an ever-shifting crowd, but rather as co-venturers who have entrusted their funds to us for what may well turn out to be the remainder of their lives.

The evidence suggests that most Berkshire shareholders have indeed embraced this long-term partnership concept. The annual percentage turnover in Berkshire's shares is a small fraction of that occurring in the stocks of other major American corporations, even when the shares I own are excluded from the calculation.

In effect, our shareholders behave in respect to their Berkshire stock much as Berkshire itself behaves in respect to companies in which it has an investment. As owners of, say, Coca-Cola or Gillette shares, we think of Berkshire as being a non-managing partner in two extraordinary businesses, in which we measure our success by the long-term progress of the companies rather than by the month-to-month movements of their stocks. In fact, we would not care in the least if several years went by in which there was no trading, or quotation of prices, in the stocks of those companies. If we have good long-term expectations, short-term price changes are meaningless for us except to the extent they offer us an opportunity to increase our ownership at an attractive price.

2. *In line with Berkshire's owner-orientation, most of our directors have a major portion of their net worth invested in the company. We eat our own cooking*.

Charlie's family has [80–90%] of its net worth in Berkshire shares; and I have about [98–99%]. In addition, many of my relatives—my sisters and cousins, for example—keep a huge portion of their net worth in Berkshire stock.

Charlie and I feel totally comfortable with this eggs-in-one-basket situation because Berkshire itself owns a wide variety of truly extraordinary businesses. Indeed, we believe that Berkshire is close to being unique in the quality and diversity of the businesses in which it owns either a controlling interest or a minority interest of significance.

Charlie and I cannot promise you results. But we can guarantee that your financial fortunes will move in lockstep with ours for whatever period of time you elect to be our partner. We have no interest in large salaries or options or other means of gaining an "edge" over you. We want to make money only when our partners do and in exactly the same proportion. Moreover, when I do something dumb, I want you to be able to derive some solace from the fact that my financial suffering is proportional to yours.

3. *Our long-term economic goal (subject to some qualifications mentioned later) is to maximize Berkshire's average annual rate of gain in intrinsic*

business value on a per-share basis. We do not measure the economic significance or performance of Berkshire by its size; we measure by per-share progress. We are certain that the rate of per-share progress will diminish in the future—a greatly enlarged capital base will see to that. But we will be disappointed if our rate does not exceed that of the average large American corporation.

4. *Our preference would be to reach our goal by directly owning a diversified group of businesses that generate cash and consistently earn above-average returns on capital. Our second choice is to own parts of similar businesses, attained primarily through purchases of marketable common stocks by our insurance subsidiaries. The price and availability of businesses and the need for insurance capital determine any given year's capital allocation.*

In recent years, we made a number of acquisitions. Though there will be dry years also, we expect to make a number of acquisitions in the decades to come, and our hope is that they will be large. If these purchases approach the quality of those we have made in the past, Berkshire will be well served.

The challenge for us is to generate ideas as rapidly as we generate cash. In this respect, a depressed stock market is likely to present us with significant advantages. For one thing, it tends to reduce the prices at which entire companies become available for purchase. Second, a depressed market makes it easier for our insurance companies to buy small pieces of wonderful businesses—including additional pieces of business we already own—at attractive prices. And third, some of those same wonderful businesses, such as Coca-Cola, are consistent buyers of their own shares, which means that they, and we, gain from the cheaper prices at which they can buy.

Overall, Berkshire and its long-term shareholders benefit from a sinking stock market much as a regular purchaser of food benefits from declining food prices. So when the market plummets—as it will from time to time—neither panic nor mourn. It's good news for Berkshire.

5. *Because of our two-pronged approach to business ownership and because of the limitations of conventional accounting, consolidated reported earnings may reveal relatively little about our true economic performance. Charlie and I, both as owners and managers, virtually ignore such consolidated numbers. However, we will also report to you the earnings of each major business we control, numbers we consider of great importance. These figures, along with other information we will supply about the individual businesses, should generally aid you in making judgments about them.*

To state things simply, we try to give you in the annual report the numbers and other information that really matter. Charlie and I pay a great deal of attention to how well our businesses are doing, and we also work to understand the environment in which each business is operating. For example, is one of our businesses enjoying an industry tailwind or is it facing a headwind? Charlie and I need to know exactly which situation prevails and to adjust our expectations accordingly. We will also pass along our conclusions to you.

Over time, the large majority of our businesses have exceeded our expectations. But sometimes we have disappointments, and we will try to be as candid in informing you about those as we are in describing the happier experiences. When we use unconventional measures to chart our progress, we will try to explain these concepts and why we regard them as important. In other words, we believe in telling you how we think so that you can evaluate not only Berkshire's businesses but also assess our approach to management and capital allocation.

6. *Accounting consequences do not influence our operating or capital-allocation decisions. When acquisition costs are similar, we much prefer to purchase $2 of earnings that is not reportable by us under standard accounting principles than to purchase $1 of earnings that is reportable. This is precisely the choice that often faces us since entire businesses (whose earnings will be fully reportable) frequently sell for double the pro-rata price of small portions (whose earnings will be largely unreportable). In aggregate and over time, we expect the unreported earnings to be fully reflected in our intrinsic business value through capital gains.*

We have found over time that the undistributed earnings of our investees, in aggregate, have been as fully as beneficial to Berkshire as if they had been distributed to us (and therefore had been included in the earnings we officially report). This pleasant result has occurred because most of our investees are engaged in truly outstanding businesses that can often employ incremental capital to great advantage, either by putting it to work in their businesses or by repurchasing their shares. Obviously, every capital decision that our investees have made has not benefitted us as shareholders, but overall we have garnered far more than a dollar of value for each dollar they have retained. We consequently regard look-through earnings as realistically portraying our yearly gain from operations.

7. *We use debt sparingly and, when we do borrow, we attempt to structure our loans on a long-term fixed-rate basis. We will reject interesting opportunities rather than over-leverage our balance sheet. This conservatism has penalized our results but it is the only behavior that leaves us comfortable, considering our fiduciary obligations to policyholders, lenders and the many equity holders who have committed unusually large portions of their net worth to our care. (As one*

of the Indianapolis "500" winners said: "To finish first, you must first finish.")

The financial calculus that Charlie and I employ would never permit our trading a good night's sleep for a shot at a few extra percentage points of return. I've never believed in risking what my family and friends have and need in order to pursue what they don't have and don't need.

Besides, Berkshire has access to two low-cost, non-perilous sources of leverage that allow us to safely own far more assets than our equity capital alone would permit: deferred taxes and "float," the funds of others that our insurance business holds because it receives premiums before needing to pay out losses. Both of these funding sources have grown rapidly and now total about $100 billion.

Better yet, this funding to date has been cost-free. Deferred tax liabilities bear no interest. And as long as we can break even in our insurance underwriting, the cost of the float developed from that operation is zero. Neither item, it should be understood, is equity; these are real liabilities. But they are liabilities without covenants or due dates attached to them. In effect, they give us the benefit of debt—an ability to have more assets working for us—but saddle us with none of its drawbacks.

Of course, there is no guarantee that we can obtain our float in the future at no cost. But we feel our chances of attaining that goal are as good as those of anyone in the insurance business. Not only have we reached the goal in the past (despite a number of important mistakes by your Chairman), our 1996 acquisition of GEICO materially improved our prospects for getting there in the future. [Since 2011], we expect additional borrowings to be concentrated in our utilities and railroad businesses, loans that are non-recourse to Berkshire. Here, we will favor long-term, fixed-rate loans. When we make a truly large purchase, as we did with BNSF, we will borrow money at the parent company level with the intent of quickly paying it back.

8. *A managerial "wish list" will not be filled at shareholder expense. We will not diversify by purchasing entire businesses at control prices that ignore long-term economic consequences to our shareholders. We will only do with your money what we would do with our own, weighing fully the values you can obtain by diversifying your own portfolios through direct purchases in the stock market.*

Charlie and I are interested only in acquisitions that we believe will raise the *per-share* intrinsic value of Berskhire's stock. The size of our paychecks or our offices will never be related to the size of Berkshire's balance sheet.

9. *We feel noble intentions should be checked periodically against results. We test the wisdom of retaining earnings by assessing whether retention, over*

time, delivers shareholders at least $1 of market value for each $1 retained. To date, this test has been met. We will continue to apply it on a five-year rolling basis. As our net worth grows, it is more difficult to use retained earnings wisely.

I should have written the "five-year rolling basis" sentence differently, an error I didn't realize until I received a question about this subject at the 2009 annual meeting.

When the stock market has declined sharply over a five-year stretch, our market-price premium to book value has sometimes shrunk. And when that happens, we fail the test as I improperly formulated it. In fact, we fell far short as early as 1971-75, well before I wrote this principle in 1983.

The five-year test should be: (1) during the period did our book-value gain exceed the performance of the S&P; and (2) did our stock consistently sell at a premium to book, meaning that every $1 of retained earnings was always worth more than $1? If these tests are met, retaining earnings has made sense.

10. *We will issue common stock only when we receive as much in business value as we give. This rule applies to all forms of issuance—not only mergers or public stock offerings, but stock-for-debt swaps, stock options, and convertible securities as well. We will not sell small portions of your company—and that is what the issuance of shares amounts to—on a basis inconsistent with the value of the entire enterprise.*

When we sold the Class B shares in 1996, we stated that Berkshire stock was not undervalued—and some people found that shocking. That reaction was not well-founded. Shock should have registered instead had we issued shares when our stock *was* undervalued. Managements that say or imply during a public offering that their stock is undervalued are usually being economical with the truth or uneconomical with their existing shareholders' money: Owners unfairly lose if their managers deliberately sell assets for 80¢ that in fact are worth $1. We didn't commit that kind of crime in our offering of Class B shares and we never will. (We did *not*, however, say at the time of the sale that our stock was overvalued, though many media have reported that we did.)

11. *You should be fully aware of one attitude Charlie and I share that hurts our financial performance: Regardless of price, we have no interest at all in selling any good businesses that Berkshire owns. We are also very reluctant to sell sub-par businesses as long as we expect them to generate at least some cash and as long as we feel good about their managers and labor relations. We hope not to repeat the capital-allocation mistakes that led us into such sub-par businesses. And we react with great caution to suggestions that our poor businesses can be restored to satisfactory profitability by major capital expenditures. (The projections will be dazzling and the advocates sincere, but, in*

the end, major additional investment in a terrible industry usually is about as rewarding as struggling in quicksand.) Nevertheless, gin rummy managerial behavior (discard your least promising business at each turn) is not our style. We would rather have our overall results penalized a bit than engage in that kind of behavior.

We continue to avoid gin rummy behavior. True, we closed our textile business in the mid-1980s after 20 years of struggling with it, but only because we felt it was doomed to run never-ending operating losses. We have not, however, given thought to selling operations that would command very fancy prices nor have we dumped our laggards, though we focus hard on curing the problems that cause them to lag.

12. *We will be candid in our reporting to you, emphasizing the pluses and minuses important in appraising business value. Our guideline is to tell you the business facts that we would want to know if our positions were reversed. We owe you no less. Moreover, as a company with a major communications business, it would be inexcusable for us to apply lesser standards of accuracy, balance and incisiveness when reporting on ourselves than we would expect our news people to apply when reporting on others. We also believe candor benefits us as managers: The CEO who misleads others in public may eventually mislead himself in private*.

At Berkshire you will find no "big bath" accounting maneuvers or restructuring. And we won't "smooth" quarterly or annual results: We will always tell you how many strokes we have taken on each hole and never play around with the scorecard. When the numbers are a very rough "guesstimate," as they necessarily must be in insurance reserving, we will try to be both consistent and conservative in our approach.

We will be communicating with you in several ways. Through the annual report, I try to give all shareholders as much value-defining information as can be conveyed in a document kept to reasonable length. We also try to convey a liberal quantity of condensed but important information in our quarterly reports, though I don't write those (one recital a year is enough). Still another important occasion for communication is our Annual Meeting, at which Charlie and I are delighted to spend five hours or more answering questions about Berkshire. But there is one way we *can't* communicate: on a one-on-one basis. That isn't feasible given Berkshire's many thousands of owners.

In all of our communications, we try to make sure that no single shareholder gets an edge: We do not follow the usual practice of giving earnings "guidance" to analysts or large shareholders. Our goal is to have all of our owners updated at the same time.

13. *Despite our policy of candor we will discuss our activities in marketable securities only to the extent legally required. Good investment ideas are rare, valuable and subject to competitive appropriation just as good product or business acquisition ideas are. Therefore we normally will not talk about our investment ideas. This ban extends even to securities we have sold (because we may purchase them again) and to stocks we are incorrectly rumored to be buying. If we deny those reports but say "no comment" on other occasions, the no-comments become confirmation.*

Though we continue to be unwilling to talk about specific stocks, we freely discuss our business and investment philosophy. I benefitted enormously from the intellectual generosity of Ben Graham, the greatest teacher in the history of finance, and I believe it appropriate to pass along what I learned from him, even if that creates new and able investment competitors for Berkshire just as Ben's teachings did for him.

14. *To the extent possible, we would like each Berkshire shareholder to record a gain or loss in market value during his period of ownership that is proportional to the gain or loss in per-share intrinsic value recorded by the company during that holding period. For this to come about, the relationship between the intrinsic value and the market price of a Berkshire share would need to remain constant, and by our preferences at 1-to-1. As that implies, we would rather see Berkshire's stock price at a **fair** level than a **high** level. Obviously, Charlie and I can't control Berkshire's price. But by our policies and communications, we can encourage informed, rational behavior by owners that, in turn, will tend to produce a stock price that is also rational. Our it's-as-bad-to-be-overvalued-as-to-be-undervalued approach may disappoint some shareholders, particularly those poised to sell. We believe, however, that it affords Berkshire the best prospect of attracting long-term investors who seek to profit from the progress of the company rather than from the investment mistakes of their partners.*

15. *We regularly compare the gain in Berkshire's per-share book value to the performance of the S&P 500. Over time, we hope to outpace this yardstick. Otherwise, why do our investors need us? The measurement, however, has certain shortcomings. Moreover, it now is less meaningful on a year-to-year basis than was formerly the case. That is because our equity holdings, whose value tends to move with the S&P 500, are a far smaller portion of our net worth than they were in earlier years. Additionally, gains in the S&P stocks are counted in full in calculating that index, whereas gains in Berkshire's equity holdings are counted at 65% because of the federal tax we incur. We, therefore, expect to outperform the S&P in lackluster years for the stock market and*

underperform when the market has a strong year.

[1] [1979; 1996 Owner's Manual—originally 1983, and annually beginning in 1988, with occasional modification.]