

A full-length portrait of Warren Buffett, an elderly man with white hair and glasses, wearing a dark pinstriped suit, a white shirt, and a red patterned tie. He is standing against a dark, textured background. The text 'Forbes' is overlaid on the left side of the image.

Forbes

ON WARREN BUFFETT

CONTENTS

1 HOW OMAHA BEATS WALL STREET

Forbes discovered Warren Buffett in 1969, and this early interview introduced the iconic investor to a wide audience for the first time.

4 THE MONEY MEN

Look At All Those Beautiful, Scantly Clad Women Out There!

6 “YOU PAY A VERY HIGH PRICE IN THE STOCK MARKET FOR A CHEERY CONSENSUS”

What does Buffett think now? In this article written for FORBES he puts it bluntly: Now is the time to buy.

8 WILL THE REAL WARREN BUFFETT PLEASE STAND UP?

Warren Buffett talks like a cracker-barrel Ben Graham, but he invents sophisticated arbitrage strategies that keep him way ahead of the smartest folks on Wall Street.

12 WARREN BUFFETT’S IDEA OF HEAVEN: “I DON’T HAVE TO WORK WITH PEOPLE I DON’T LIKE”

Warren Buffett this year moves to the top of The Forbes Four Hundred. Herein he explains how he picks his uncannily successful investments and reveals what he plans on doing with all that loot he has accumulated.

18 NOT-SO-SILENT PARTNER: MEET CHARLIE MUNGER,

Here’s the lawyer who converted Warren Buffett from an old-fashioned Graham value investor to the ultimate buy-and-hold value strategist.

23 BUFFETT ON BRIDGE

As the Duke of Wellington trained on the playing fields of Eton, Warren Buffett trains at the bridge table.

25 THREE LITTLE WORDS

Warren Buffett says he doesn’t think the market is overvalued, yet he buys few stocks. Why?

27 FLYING BUFFETT

Leading a revolt of the airline business traveler.

29 THE BERKSHIRE BUNCH

Chance meetings with an obscure young investment counselor made a lot of people wildly rich. Without knowing it, they were buying into the greatest compound-interest machine ever built.

33 A SON’S ADVICE TO HIS FATHER

Howard Buffett does not expect to inherit his dad’s place on The Forbes 400, but he hardly seems bitter.

36 A WORD FROM A DOLLAR BEAR

Warren Buffett’s vote of no confidence in U.S. fiscal policies is up to \$20 billion.

ON THE COVER: BEN BAKER/REDUX



How Omaha Beats Wall Street

FORBES DISCOVERED WARREN BUFFETT IN 1969, AND THIS EARLY INTERVIEW INTRODUCED THE ICONIC INVESTOR TO A WIDE AUDIENCE FOR THE FIRST TIME.

Warren Buffett has lived in Washington and New York and studied at Columbia University Business School, but he has never stayed in these places very long. He has always returned to his home town, Omaha, Nebr. If he were a doctor or lawyer or ordinary businessman, this might not be surprising. But Buffett is what is usually called a Wall Streeter, a Money Man. For the last 12 years he has been running one of the most spectacular investment portfolios in the country.

Since adjectives like "spectacular" don't prove much, we'll tell you exactly how spectacular Buffett has been: \$10,000

invested in his Buffett Partnership in 1957 is now worth \$260,000. The partnership, recently at \$100 million, has grown at an annual compounded rate of 31%. Over that 12-year period it hasn't had one year in which it lost money. It gained 13% in 1962 and 20% in 1966, years when the Dow average fell 7% and 15%, respectively. It hasn't lost money this year, either.

"Oh," you say, "a hot stock man." Not at all.

Buffett has accomplished this through consistently following fundamental investment principles. A lot of young money men who now are turning in miserable performances began with the same investment ideas in the early Sixties but then forgot them in the Great Chase of the Hot Stock. Buffett, however, stayed with his principles. He doesn't talk about concept companies or story stocks. He has never traded for a fast turn on an earnings report or bought little unknown companies, as Fred Carr does. He doesn't hedge (i.e., go short) like A. W. Jones, who devised the hedge fund, Buffett is not a simple person, but he has simple tastes. He buys a stock for simple, basic reasons, not tortuous or sophisticated ones. His stocks, you might say, are sort of like Omaha.

His big successes over the years have been in the stocks of ordinary companies: American Express, not Control Data; Cleveland Worsted Mills, not Xerox; Walt Disney, not Kentucky Fried Chicken; Studebaker, not Tele-dyne. He won't buy a conglomerate: They don't make sense to him. Ditto technological companies: "I can't understand them. They're not my style."

Buffett tells a story on himself: "William Morris of Control Data is a relative through marriage, and I could have bought it at 16 cents a share [now \$150], but I asked: 'Who needs another computer company?'"

Besides having no use for glamour stocks or conglomer-

ates, Buffett scorns what might be called the numerology approach to the stock market—charting, resistance points, trend lines and what have you. He's a fundamentalist. "I'm 15% Phil Fisher," he says, "and 85% Benjamin Graham."

For the benefit of those not familiar with stock market literature we had better explain. Fisher and Graham are two of the great stock market fundamentalists. Fisher is what might be called a real-world fundamentalist. That is, he is primarily interested in a company's products, its people, its relationships with dealers. Graham, the now retired coauthor of the textbook *Security Analysis* and the more readable *The Intelligent Investor*, could be called a statistical fundamentalist. That is, he analyzes the basic underlying statistics, assets, sales, capitalization and their relationship to the market price. Obviously neither method is much help in picking hot new stocks because hot new stocks, by definition, don't have any fundamentals, statistical or otherwise.

Buffett studied under Graham at Columbia, later worked for him at Graham Newman Corp. But let's start from the beginning.

Born in Omaha in 1929, Buffett was taken to Washington in 1942 after his father, now deceased, was elected to the House of Representatives as a Republican. He lived there most of the time until his father retired permanently from politics in 1952. Back home in Nebraska, he studied at the University of Nebraska and pondered the stock market. "I'd been interested in the stock market from the time I was 11, when I marked the board here at Harris Upham where my father was a broker. I ran the gamut, stock tips, the Magee charting stuff, everything. Then I picked up Graham's *Security Analysis*. Reading it was like seeing the light." The light led Buffett back East where he studied under the Master at Columbia Business School. Then back to Omaha and selling securities for two years. In 1954, when he was 25, he started Buffett Partnership, Ltd. with \$100,000 and seven limited partners (he is the only general partner). The arrangement, still in effect, provided for Buffett to get 25% of the annual profits after each partner got 6% on his money. In 12 years this arrangement made Buffett a very rich man indeed. (He made us promise not to use a number, but figure out for yourself what would happen to even a small sum compounded for 13 years at 31%!)

Buffett has applied Graham's principles quite systematically. Says Graham in *The Intelligent Investor*: "Investment is most intelligent when it is most business-like"—in other words, not swayed by emotions, hopes, fads. This is Buffett's most important tenet. "When I buy a stock," Buffett says, "I think of it in terms of buying a whole company just as if I were buying the store down the street. If I were buying the store, I'd want to know all about it. I mean, look at what Walt Disney was worth on the stock market in the first half of 1966. The price per share was \$53, and this didn't look especially cheap, but on that basis you could buy the whole company for \$80

million when *Snow White*, *Swiss Family Robinson* and some other cartoons, which had been written off the books, were worth that much. And then you had Disneyland and Walt Disney, a genius, as a partner."

TEACHER GRAHAM: ... to distill the secret of sound investment into three words, we venture the motto: Margin of Safety.

PUPIL BUFFETT: I try to buy a dollar for 60 cents, and if I think I can get that, then I don't worry too much about when. A perfect example of this is British Columbia Power. In 1962, when it was being nationalized, everyone knew that the provincial government was going to pay at least X dollars and you could buy it for X minus, say, 5. As it turned out, the government paid a lot more.

GRAHAM: The investor with a portfolio of sound stocks ... should neither be concerned by sizable declines nor become excited by sizable advances.

BUFFETT: Imagine if you owned grocery store and you had a manic-depressive partner who one day would offer to sell you his share of the business for a dollar. Then the next day because the sun was shining or for no reason at all wouldn't sell for any price. That's what the market is like and why you can't buy and sell on its terms. You have to buy and sell when you want to.

Almost any of Buffett's investments fall into this category, since he buys them when the price is going down and sells when they're going up. Unlike Phil Fisher but like Ben Graham, Buffett doesn't talk about evaluating management except in the very basic terms of whether it is trustworthy or not. His American Express investment is a perfect example of how his mind works. Buffett bought American Express after the salad oil scandal but not before doing some fast research on his own, which among other things included talking to the company's competitors and going over restaurant receipts in an Omaha steak house. All of this convinced Buffett that American Express had an unassailable position in travelers' checks and was fast developing the same sort of position in credit cards.

"Look," says Buffett, "the name American Express is one of the greatest franchises in the world. Even with terrible management it was bound to make money. American Express was last in the traveler's check market and had to compete with the two largest banks in the country. Yet after a short time it had over 80% of the business, and no one has been able to shake this position."

Not for Warren Buffett are computers or a vast staff and impressive offices. Until recently, even when he was managing \$20 million, Warren Buffett was the entire staff of Buffett Partnership, Ltd. Even today the staff consists of four housed

in three small rooms in Omaha's Kiewit Plaza. He gets some of his best ideas thumbing through Moody's investment manuals, financial and general publications like the *Wall Street Journal*, *New York Times* and the *American Banker*, and industry journals when a specific industry interests him. This is the way he bought Western Insurance at \$16 when it was earning \$16 a share, and National American Insurance at one times earnings in the 1950s. Then in 1962 he found Gurdon Wattles' American Manufacturing selling at a 40% discount from net worth. "If you went to Wattles of American Manufacturing or Howard Ahmanson of National American Insurance and asked them to be partners, you could never get in at one times earnings," says Buffett.

When the reading puts him on to something, he'll do some informal field research. In one case in 1965 Buffett says he spent the better part of a month counting tank cars in a Kansas City railroad yard. He was not, however, considering buying railroad stocks. He was interested in the old Studebaker Corp. because of STP, a highly successful gasoline additive. The company wouldn't tell him how the product was doing. But he knew that the basic ingredient came from Union Carbide, and he knew how much it took to produce one can of STP. Hence the tank-car counting. When shipments rose, he bought Studebaker stock, which subsequently went from 18 to 30.

Buffett is one of those disciplined types who is perfectly willing to sell too soon. As Buffett puts it, he tries to buy \$1 worth of stock for 60 cents, and when it goes to \$1, he sells it, even if it looks like it is going higher. With that kind of investing, he doesn't have to worry too much about dips in the market. Nor about "stories" or "concepts": "If the stock doesn't work out in the context I picked it for, it probably will in another," he says. Example: He bought his Disney stock with his eye on basic value, but it first went up when Disney died and has continued to rise because of the leisure boom. Says Buffett: "With value like that I know I'm not going to get stuck with a Kentucky Fried Computer when it goes out of fashion."

As his fund got bigger and bigger, Buffett began taking bigger and bigger positions, because his basic policy was to hold only nine or ten stocks. At one point, before selling the stock in May 1964, Buffett Partnership owned 5% of American Express. Inevitably, this led him to some control situa-

tions. For example, he and his friends own 70% of the stock of Berkshire Hathaway, a New England textile manufacturer that Buffett originally got into because the company had working capital of \$11 a share versus a stock price of \$7. They also own several small businesses.

AND SO, GOOD-BYE ...

Alas, good reader, if all this appeals to you, forget about having Warren Buffett handle your money. From now on he's not going to be handling anybody's except his own. After this coming January Buffett is closing up shop and dissolving the partnership. He has no desire to be a Getty or a Rockefeller. Besides, he's getting stale. "My idea quota used to be like Niagara Falls—I'd have many more than I could use. Now it's as if someone had dammed up the water and was letting it flow with an eyedropper." He attributes his problem to a market that no longer lends itself to his kind of analysis, where real values are hard to find. He blames some of it on the Performance Game; so many people are playing it now that, by definition, few will be able to get above-average results. Also, conglomerates and tender offers have picked off many of the bargains. But this may be—and probably is—mere rationalization. The motives behind Buffett's quitting are probably much simpler. He has made a fortune and is no longer motivated to count boxcars and read statistical manuals. He comes close to the truth when he says: "You shouldn't be doing at 60 what you did at 20." He plans putting most of his money into municipal bonds, for income, and he'll continue to hold companies where he has a controlling interest: Berkshire-Hathaway, the Illinois National Bank in Rockford, Ill. and a small Omaha weekly newspaper. He is interested in public affairs, but he plans to back various projects from off-stage. What else? "I don't believe in making life plans," is all he will say.

Buffett plans to continue living in the rambling old Omaha house, typically suburban, where he has lived since his marriage in 1952; whenever he has needed more space he simply tacked on another room, including an indoor handball court, which keeps him lean. Here the pace isn't frantic and his three children can have a healthy upbringing. Of course, everybody knows the smart boys gravitate to Wall Street. Only the sluggards stay home. **F**

**WE HAVE EMBRACED THE 21ST CENTURY
BY ENTERING SUCH CUTTING-EDGE
INDUSTRIES AS BRICK, CARPET,
INSULATION AND PAINT. TRY TO CONTROL
YOUR EXCITEMENT. —WARREN BUFFETT**

How do you contemplate the current stock market, we asked Warren Buffett, the sage of Omaha, Nebr. "Like an oversexed guy in a harem," he shot back. "This is the time to start investing."

The Dow was below 600 when he said that. Before we could get Buffett's words in print, it was up almost 15% in one of the fastest rallies ever.

We called him back and asked if he found the market as sexy at 660 as he did at 580. "I don't know what the averages are going to do next," he replied, "but there are still plenty of bargains around." He remarked that the situation reminded him of the early Fifties.

Warren Buffett doesn't talk much, but when he does he's well worth listening to. His sense of timing has been remarkable. Five years ago, late in 1969, when he was 39, he called it quits on the market. He liquidated his money management pool, Buffett Partnership, Ltd., and gave his clients their money back. Before that, in good years and bad, he had been beating the averages, making the partnership grow at a com-

puted annual rate of 30% before fees between 1957 and 1969. (That works out to a \$10,000 investment growing to \$300,000 and change.) He quit essentially because he found the game no longer worth playing. Multiples on good stocks were sky-high, the go-go boys were "performing" and the list was so picked over that the land of solid bargains that Buffett likes were not to be had. He told his clients that they might do better in tax-exempt bonds than in playing the market. "When I got started," he says, "the bargains were flowing like the Johnstown flood; by 1969 it was like a leaky toilet in Altoona." Pretty cagey, this Buffett. When all the sharp M.B.A.s were crowding into the investment business, Buffett was quietly walking away.

Buffett settled back to manage the business interests he had acquired, including Diversified Retailing, a chain of women's apparel stores; Blue Chip Stamps, a western states trading stamp operation; and Berkshire Hathaway, a diversified banking and insurance company that owned, among other things, a weekly newspaper, *The Omaha Sun*. The busi-

The Money Men

LOOK AT ALL THOSE BEAUTIFUL, SCANTILY CLAD WOMEN OUT THERE!



nesses did well. Under Buffett's management the *Sun* won a Pulitzer Prize for its expose of how Boys Town, despite pleas of poverty, had been turned into a "moneymaking machine."

SWING, YOU BUM!

Buffett is like the legendary guy who sold his stocks in 1928 and went fishing until 1933. That guy probably didn't exist. The stock market is habit-forming: You can always persuade yourself that there are bargains around. Even in 1929. Or 1970. But Buffett did kick the habit. He did "go fishing" from 1969 to 1974. If he had stuck around, he concedes, he would have had mediocre results. "I call investing the greatest business in the world," he says, "because you never have to swing. You stand at the plate, the pitcher throws you General Motors at 47! U.S. Steel at 39! and nobody calls a strike on you. There's no penalty except opportunity lost. All day you wait for the pitch you like; then when the fielders are asleep, you step up and hit it."

But pity the pros at the investment institutions. They're the victims of impossible "performance" measurements. Says Buffett, continuing his baseball imagery, "It's like Babe Ruth at bat with 50,000 fans and the club owner yelling, 'Swing, you bum!' and some guy is trying to pitch him an intentional walk. They know if they don't take a swing at the next pitch, the guy will say, 'Turn in your uniform.'" Buffett claims he set up his partnership to avoid these pressures.

Stay dispassionate and be patient, is Buffett's message. "You're dealing with a lot of silly people in the marketplace; it's like a great big casino and everyone else is boozing. If you can stick with Pepsi, you should be okay." First the crowd is boozing on optimism and buying every new issue in sight. The next moment it is boozing on pessimism, buying gold bars and predicting another Great Depression.

Fine, we said, if you're so bullish, what are you buying? His answer: "I don't want to tout my own stocks."

Any general suggestions, we asked? Just commonsense ones. Buy stocks that sell at ridiculously low prices. Low by what standards? By the conventional ones of net worth, book value, the value of the business as a going concern. Above all, stick with what you know; don't get too fancy. "Draw a circle around the business you understand and then eliminate those that fail to qualify on basis of value, good management and limited exposure to hard times." No high technology. No multicompanies. "I don't understand them," says Buffett. "Buy into a company because you want to own it, not because you want the

stock to go up.

"A water company is pretty simple," he says, adding that Blue Chip Stamps has a 5% interest in the San Jose Water Works. "So is a newspaper. Or a major retailer." He'll even buy a Street favorite if he isn't paying a big premium for things that haven't happened yet. He mentions Polaroid. "At some price you don't pay anything for the future, and you even discount the present. Then, if Dr. Land has some surprises up his sleeve, you get them for nothing."

Have faith in your own judgment, your adviser's judgment, Buffett advises. Don't be swayed by every opinion you hear and every suggestion you read. Buffett recalls a favorite saying of Professor Benjamin Graham, the father of modern security analysis and Buffett's teacher at Columbia Business School: "You are neither right nor wrong because people agree with you." Another way of saying that wisdom, truth, lie elsewhere than in the moment's moods.

What good, though, is a bargain if the market never recognizes it as a bargain? What if the stock market never comes back? Buffett replies: "When I worked for Graham-Newman, I asked Ben Graham, who then was my boss, about that. He just shrugged and replied that the market always eventually does. He was right—in the short run it's a voting machine, in the long run it's a weighing machine. Today on Wall Street they say, 'Yes, it's cheap, but it's not going to go up.' That's silly. People have been successful investors because they've stuck with successful companies. Sooner or later the market mirrors the business." Such classic advice is likely to remain sound in the future when they write musical comedies about the go-go boys.

We reminded Buffett of the old play on the Kipling lines: "If you can keep your head when all about you are losing theirs . . . maybe they know something you don't."

Buffett responded that, yes, he was well aware that the world is in a mess. "What the De Beers did with diamonds, the Arabs are doing with oil; the trouble is we need oil more than diamonds." And there is the population explosion, resource scarcity, nuclear proliferation. But, he went on, you can't invest in the anticipation of calamity; gold coins and art collections can't protect you against Doomsday. If the world really is burning up, "you might as well be like Nero and say, 'It's only burning on the south side.'"

"Look, I can't construct a disaster-proof portfolio. But if you're only worried about corporate profits, panic or depression, these things don't bother me at these prices." Buffett's final word: "Now is the time to invest and get rich." **F**

**WHEN A MANAGER WITH A REPUTATION FOR
BRILLIANCE TACKLES A BUSINESS WITH A REPUTATION
FOR BAD ECONOMICS, THE REPUTATION OF THE
BUSINESS REMAINS INTACT.**

Pension fund managers continue to make investment decisions with their eyes firmly fixed on the rearview mirror. This generals-fighting-the-last-war approach has proved costly in the past and will likely prove equally costly this time around.

Stocks now sell at levels that should produce long-term returns far superior to bonds. Yet pensions managers, usually encouraged by corporate sponsors they must necessarily please ("whose bread I eat, his song I sing"), are pouring funds in record proportions into bonds.

Meanwhile, orders for stocks are being placed with an eyedropper. Parkinson—of Parkinson's law fame—might conclude that the enthusiasm of professionals for stocks varies proportionately with the recent pleasure derived from ownership. This always was the way John Q. Public was expected to behave. John Q. Expert seems similarly afflicted. Here's the record.

In 1972, when the Dow earned \$67.11, or 11%, on beginning book value of 607, it closed the year selling at 1020 and pension managers couldn't buy stocks fast enough. Purchases of equities in 1972 were 105% of net funds available (i.e., bonds were sold), a record except for the 122% of the even more buoyant prior year. This two-year stampede increased the equity portion of total pension assets from 61% to 74%—an alltime record that coincided nicely with a record high price for the Dow. The more investment managers paid for stocks, the better they felt about them.

And then the market went into a tailspin in 1973-74. Although the Dow earned \$99.04 in 1974, or 14% on beginning book value of 690, it finished the year selling at 616. A bargain?

Alas, such bargain prices produced panic rather than purchases; only 21% of net investable funds went into equities that year, a 25-year record low. The proportion of equities held by private noninsured pension plans fell to 54% of net assets, a full 20-point drop from the level deemed appropriate when the Dow was 400 points higher.

By 1976 the courage of pension managers rose in tandem with the price level, and 56% of available funds was committed to stocks. The Dow that year averaged close to 1000, a level then about 25% above book value.

In 1978 stocks were valued far more reasonably, with the Dow selling below book value most of the time. Yet a new low of 9% of net funds was invested in equities during the year. The first quarter of 1979 continued at very close to the same level.

By these actions pension managers, in record-setting manner, are voting for purchase of bonds—at interest rates of 9% to 10%—and against purchase of American equities at prices ag-

gregating book value or less. But these same pension managers probably would concede that those American equities, in aggregate and over the longer term, would earn about 13% (the average in recent years) on book value. And, overwhelmingly, the managers of their corporate sponsors would agree.

Many corporate managers, in fact, exhibit a bit of schizophrenia regarding equities. They consider their own stocks to be screamingly attractive. But, concomitantly, they stamp approval on pension policies rejecting purchases of common stocks in general. And the boss, while wearing his acquisition hat, will eagerly bid 150% to 200% of book value for businesses typical of corporate America but, wearing his pension

“You pay a very high price in the stock market for a cheery consensus”

WHAT DOES BUFFETT THINK NOW?
IN THIS ARTICLE WRITTEN FOR FORBES
HE PUTS IT BLUNTLY:
NOW IS THE TIME TO BUY.

BY WARREN BUFFETT

hat, will scorn investment in similar companies at book value. Can his own talents be so unique that he is justified both in paying 200 cents on the dollar for a business if he can get his hands on it, and in rejecting it as an unwise pension investment at 100 cents on the dollar if it must be left to be run by his companions at the Business Roundtable?

A simple Pavlovian response may be the major cause of this puzzling behavior. During the last decade stocks have produced pain—both for corporate sponsors and for the investment managers the sponsors hire. Neither group wishes to return to the scene of the accident. But the pain has not been produced because business has performed badly, but rather because stocks have underperformed business. Such underperformance cannot prevail indefinitely, any more than could the earlier overperformance of stocks versus business that lured pension money into equities at high prices.

Can better results be obtained over, say, 20 years from a group of 9 1/2% bonds of leading American companies maturing in 1999 than from a group of Dow-type equities purchased, in aggregate, at around book value and likely to earn, in aggregate, around 13% on that book value? The probabilities seem exceptionally low. The choice of equities would prove inferior only if either a major sustained decline in return on equity occurs or a ludicrously low valuation of earnings prevails at the end of the 20-year period. Should price/earnings ratios expand over the 20-year period—and that 13% return on equity be averaged—purchases made now at book value will result in better than a 13% annual return. How can bonds at only 9 1/2% be a better buy?

Think for a moment of book value of the Dow as equivalent to par, or the principal value of a bond. And think of the 13% or so expectable average rate of earnings on that book value as a sort of fluctuating coupon on the bond—a portion of which is retained to add to principal amount just like the interest return on U.S. Savings Bonds. Currently our “Dow Bond” can be purchased at a significant discount (at about 840 vs. 940 “principal amount,” or book value of the Dow). *That Dow Bond purchased at a discount with an average coupon of 13%—even though the coupon will fluctuate with business conditions—seems to me to be a long-term investment far superior to a conventional 9 1/2% 20-year bond purchased at par.

Of course there is no guarantee that future corporate earnings will average 13%. It may be that some pension managers shun stocks because they expect reported returns on equity to fall sharply in the next decade. However, I don't believe such a view is widespread.

Instead, investment managers usually set forth two major objections to the thought that stocks should now be favored over bonds. Some say earnings currently are overstated, with

real earnings after replacement-value depreciation far less than those reported. Thus, they say, real 13% earnings aren't available. But that argument ignores the evidence in such investment areas as life insurance, banking, fire-casualty insurance, finance companies, service businesses, etc. In those industries replacement-value accounting would produce results virtually identical with those produced by conventional accounting. And yet, one can put together a very attractive package of large companies in those fields with an expectable return of 13% or better on book value and with a price that, in aggregate, approximates book value. Furthermore, I see no evidence that corporate managers turn their backs on 13% returns in their acquisition decisions because of replacement-value accounting considerations.

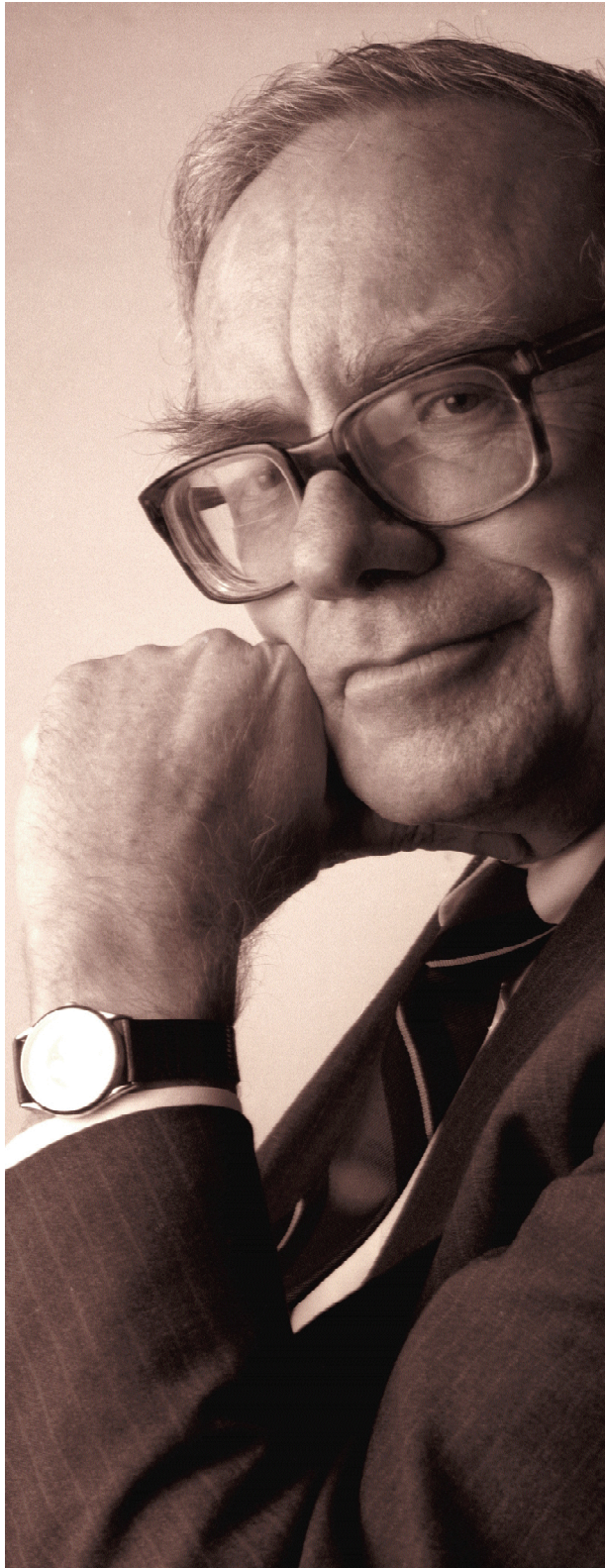
A second argument is made that there are just too many question marks about the near future; wouldn't it be better to wait until things clear up a bit? You know the prose: “Maintain buying reserves until current uncertainties are resolved,” etc. Before reaching for that crutch, face up to two unpleasant facts: The future is never clear; you pay a very high price in the stock market for a cheery consensus. Uncertainty actually is the friend of the buyer of long-term values.

If anyone can afford to have such a long-term perspective in making investment decisions, it should be pension fund managers. While corporate managers frequently incur large obligations in order to acquire businesses at premium prices, most pension plans have very minor flow-of-funds problems. If they wish to invest for the long term—as they do in buying those 20- and 30-year bonds they now embrace—they certainly are in a position to do so. They can, and should, buy stocks with the attitude and expectations of an investor entering into a long-term partnership.

Corporate managers who duck responsibility for pension management by making easy, conventional or faddish decisions are making an expensive mistake. Pension assets probably total about one-third of overall industrial net worth and, of course, bulk far larger in the case of many specific industrial corporations. Thus poor management of those assets frequently equates to poor management of the largest single segment of the business. Soundly achieved higher returns will produce significantly greater earnings for the corporate sponsors and will also enhance the security and prospective payments available to pensioners.

Managers currently opting for lower equity ratios either have a highly negative opinion of future American business results or expect to be nimble enough to dance back into stocks at even lower levels. There may well be some period in the near future when financial markets are demoralized and much better buys are available in equities; that possibility exists at all times. But you can be sure that at such a time the future will seem neither predictable nor pleasant. Those now awaiting a “better time” for equity investing are highly likely to maintain that posture until well into the next bull market. **F**

* Figures are based on the old Dow, prior to the recent substitutions. The returns would be moderately higher and the book values somewhat lower if the new Dow had been used.



WILLIAM COUPON/CORBIS

Will the Real Warren Buffett Please Stand Up?

WARREN BUFFETT TALKS LIKE A CRACKER-BARREL BEN GRAHAM, BUT HE INVENTS SOPHISTICATED ARBITRAGE STRATEGIES THAT KEEP HIM WAY AHEAD OF THE SMARTEST FOLKS ON WALL STREET.

BY TATIANA POUSCHINE
WITH CAROLYN TORCELLINI

Warren Buffett quotes Benjamin Graham, who was quoting the Danish philosopher Søren Kierkegaard: "Life must be lived forward but judged backwards."

FORBES came to talk investments with the billionaire considered by many the ultimate investor of the later 20th century. Why is Berkshire Hathaway's 59-year-old chairman quoting a dead investment thinker quoting a long-ago philosopher?

Warren Buffett is making a fine point. It's this: In retrospect it's easy to see how he made 30% annual compound returns over many years; looking ahead it's not clear how he's going to keep beating the market; but because something is unclear doesn't mean it can't happen.

This is Buffett's indirect answer to those who—like the author of a recent article in *Barron's*—say that Berkshire Hathaway at a 65% premium to stated net asset value is a grossly overvalued stock. What investment company—and that's

what Berkshire Hathaway is—could be worth that kind of a premium? Even Buffett concedes he won't be able to multiply money as fast in the future as he did in the past.

But he isn't conceding that he can't continue beating the averages.

No, the future isn't visible as the past is, but that was true, too, in the decades when the Buffett legend was created. If everybody had seen what he had seen, he wouldn't have made huge gains from his visions. From the evidence, he hasn't lost the talent of seeing ahead.

In the 1970s Buffett saw that media companies, especially big-city newspapers, were cheap relative to the earning power of their entrenched positions—their franchises—as well as logical innovations about to be introduced. That seems obvious now, but it wasn't then. He made large investments in the *Buffalo News*, the Washington Post Co., Affiliated Publications. People who didn't see what he saw gladly sold him shares at prices that now look ridiculously cheap.

When the public caught on, Buffett had to find another vision. In the 1980s Buffett was among the first to appreciate the values in consumer brand names.

Go back far enough in Buffett's 49-year investment career and you'll find this disciple of Benjamin Graham buying Ben Graham stocks: stocks selling so cheap that you had to pay only for the working capital and you got the rest of the assets for nothing. But such stocks all but vanished after the 1960s, and Buffett adapted the Graham net-working capital approach to a much more expensive stock market.

He began buying stocks that were cheap, not on balance sheet analysis but on off-balance-sheet analysis. A brand name might be carried on the books at \$1 but worth billions. These brand names were often more valuable than tangible assets like cash and inventory and real estate. But, not appearing on balance sheets, they were rarely capitalized by prevailing security analysis techniques.

Buffett bought General Foods, Beatrice and RJR Nabisco. On General Foods alone he more than doubled his money when he sold in 1985.

During the takeover mania of the 1980s Buffett bought shares at everyday market prices. Then he waited for somebody else to do a takeover—as in General Foods—or just sat until the market recognized the value he saw—as in Capital Cities.

But that, as Kierkegaard would say, is the judgment, the backwards part. Conditions have changed as the buyout wave eliminated many stocks selling at prices that ignored intangible values. Living his life forward, Buffett began feeling for different profit opportunities. In 1987 he dabbled in arbitrage. Here's how:

“We look at the arbitrage deal, once something is announced. We look at what they've announced, what we think it will be worth, what we will have to pay, how long we're going to be in. We try to calculate the probability it will go through. That's the calculation, and the name [of the com-

panies involved] doesn't make much difference.” Like a horse-player, he bets the jockeys and not the horses. Maybe not surprising in a man who, according to John Train writing in *The Money Masters*, sold horse-racing handicapping sheets under the name *Stable Boy Selections* in his native Omaha, Nebr. at the ripe age of 12.

How has he done as an arbitrage handicapper? Pretty darned well. To find out, FORBES collected the state insurance commissions' filings on all 12 of Berkshire Hathaway's insurance companies; it is the money from these companies that provides most of Berkshire Hathaway's investment funds. What deals did Buffett play? Some picks came as no surprise: Philip Morris, RJR Nabisco and Kraft. Other names were more surprising: Interco, Federated, Southland and Marine Midland. Here are some deals FORBES looked at.

In 1987 he bet relatively small amounts. A \$2.7 million investment in Southland on Oct. 10 turned into \$3.3 million just ten days later—on an annualized basis that's a 740% return. What fun.

There were, of course, plenty of losers and break-evens in that crash year. Still, overall in 1987 Buffett's arbitrage activities earned a 90% return versus the S&P's 5%.

Emboldened, Buffett increased the arbitrage stakes. In 1988 he bet on almost 20 different deals, putting in as much as \$120 million. Net net, Buffett's trades' equally weighted average annual return would have been 35%, compared with the S&P 17.07% gain.

Most folks find a winning strategy and keep riding it for too long. Buffett's sensitive antennae have saved him from that—so far. Buffett's enthusiasm for arbitrage quickly cooled early last year when he lost 31% on his investments. This was even before the UAL debacle and the collapse in junk bonds marked the end of the wilder stages of the takeover game. But Buffett was already playing a different arbitrage game.

The new game has kept his name in the news a lot in recent months, even though almost nobody really figured out what he was doing as he took stakes in huge companies like Coca-Cola, Salomon, Inc., Gillette, USAir, Champion International.

What was he really doing?

The instrument Buffett uses for his new game is convertible preferred stock. To most people that's a timid way of playing a situation. Buffett uses the instrument differently.

Let's look at his opening bid in the game in a deal Buffett did with John Gutfreund, chairman of Salomon Brothers, in September 1987. Salomon was then under threat of a takeover from Revlon's Ronald Perelman. Gutfreund needed a friendly investor, and Buffett has a carefully cultivated image as friendly to the managements of companies he invests in.

Salomon sold Berkshire a new Salomon Brothers preferred stock issue, in the amount of \$700 million. Converted, the shares would have represented 12% of Salomon's capitalization and thus an effective barrier to a hostile takeover. It

also brought Buffett two influential seats on Salomon's board.

But note that Buffett didn't commit to Salomon's volatile common stock. The preferred issue yielded 9% and was convertible after three years into Salomon common stock at \$38—a premium of only 2.7% to the market price at a time when a typical premium for convertible preferreds was 20% to 25%. Berkshire Hathaway had a call on common at a relatively modest premium over market and way below Salomon's old highs.

And there was another kicker in the form of a fat tax advantage for Buffett. We'll get to this tax advantage later.

Starting in July 1989 Buffett negotiated three more such deals, all structured similarly to the Salomon one. In July Buffett bought \$600 million of special Gillette preferreds, yielding 8 3/4% (against 2% on Gillette common today) and convertible at an 18% premium to the then market price of the common. Prospectively the deal put 11% of Gillette's stock in Buffett's hands and offered protection against another hostile bid from the like of Coniston Partners.

Last summer airline stocks were the takeover rage, and USAir, like Salomon Brothers, also wanted a white knight. Buffett in August bought \$358 million of USAir preferred bearing a 9 1/4% quarterly dividend but with a convertible premium of 17% and an option to redeem two years later.

Buffett's most recent such deal was signed in December. Champion International, one of the world's largest paper producers, wanted an ally and invited Buffett in. Buffett put \$300 million into convertible preferred at a 9 1/4% yield (Champion common now yields only 3.6%), redeemable in 1999, granting Berkshire a 7.8% vote, at a 30% conversion premium.

The Coca-Cola investment raised eyebrows. What was a Ben Grahamite doing buying 7% of a company whose stock sold for five times book value? Accumulating 23.4 million shares over months at an average price of \$44 a share (\$45 was the high for 1988), Buffett wasn't spending \$1 billion on an unknown. He bought Coke at a multiple of 13 times estimated 1989 earnings when the overall market was trading at 11 times.

Buffett, however, denies the purchase violates his precepts of value investing. He says Coke's price didn't reflect the all-but-guaranteed growth of international sales in a world that is increasingly uniform in its tastes. But he also felt shareholder value could be enhanced by more aggressive use of capital. Since he bought in, the firm has announced it would buy back up to 20 million shares, or 6% of the common—a Buffett hallmark. Since Buffett joined the board it has also announced an 18% increase in Coke's dividend payout, a move that will make the stock look less rich.

The market seems to have come to agree. After Coca-Cola sold its 49% interest in Columbia Pictures Entertainment to Sony last fall, Coke booked \$530 million in gains while adding \$1.1 billion in cash to its balance sheet. The stock rose to 81; Buffett already has a gain of \$600 million.

And what about the other recent deals? Aren't they just an indirect way of buying the stocks of Salomon Brothers, Champion, USAir and Gillette? Yes and no. "I wouldn't have bought any of them on an equity basis," Buffett tells FORBES. "This [buying convertible preferred issues] is lending money, plus an equity kicker." But you can look at what he is doing the other way around. Buffett was buying Gillette stock with a yield kicker. What, then, does he mean by saying he wouldn't buy Gillette stock on an equity basis? Merely that the straight common stock is too risky. The convertible is much safer than the stock because it carries the option to put it back to the company as a fixed-income investment. It can be a stock or a bond—at Buffett's option. If Gillette's earnings fall apart, Buffett doesn't convert the preferred into stock, and it retains value as a fixed-income investment.

(This was one of the mistakes in the *Barron's* article; it valued the convertibles only in terms of the underlying stocks rather than valuing them as an ideal mix of stock and bond.)

Buffett gets a special deal, but so does management. Management is happy to give him a good total yield, because it can be fairly sure he's not going to kick them out and take over.

Put differently, how much does Warren Buffett charge for takeover protection? Let's look closer at the Champion deal. In 1986 Champion sold to the public a convertible bond, due in 2011. The issue pays 6.5% and is convertible into Champion common at \$34.75 per share.

Compare this with the deal Buffett got. His Champion preferred pays 9 1/4%, and Buffett can convert within two years at \$38 a share—a 30% premium to Champion's current price. Buffett got a much better yield than the public.

Greenmail? Not at all. It's whitemail, and it pays nicely.

Let's talk about some of the smart ways Buffett plays the tax laws. Last September Berkshire Hathaway marketed \$903 million worth of convertible bonds (through Salomon Brothers, of course). The Berkshire Hathaway paper is a zero coupon convertible. It yields 5.5% and matures in 15 years. It is convertible over the next 3 years into Berkshire Hathaway common stock at \$9,815—a heavy premium to Berkshire Hathaway's then price and an even heftier premium to its asset value.

So, from the start, Berkshire's shareholders are ahead. They borrow at 5.5% and lend at 9% or so; banks should have it so good. Berkshire demands a conversion premium on its inflated stock of 15% and then turns and invests the money in situations where the conversion premium averages about the same. Another thing: Buyers of Berkshire's zeros don't get cash, but Berkshire collects cash on its preferred dividends.

You can also look at the Berkshire money-raising as highly sophisticated arbitrage. Buffett was in effect selling in the futures market a richly priced security—Berkshire Hathaway—and using the proceeds to buy long, relatively undervalued securities such as Champion and USAir.

But we haven't finished parsing Buffett's complex arbi-

trage. We mentioned earlier that Buffett's deals are even better than they look because there is a tax gimmick. What is it?

Michael Harkins, a New York money manager who follows Buffett's maneuvers, calls Buffett "a masterful tax arbitrager." What he means is that Buffett structures both his borrowing and his buying so as to exploit some of the madness in the Byzantine tax code Congress has inflicted on the nation. The tax code says interest is tax deductible but dividends are not. This provision in the tax code is largely responsible for the takeover madness that swept the country last year.

Buffett has exploited the tax code in his usual subtle, cautious way. He makes most of his investments not through Berkshire Hathaway itself but through Berkshire's insurance companies. The insurance companies receive the dividends on the preferred issues. As corporations these insurance companies take advantage of a partial tax exemption for dividends they receive from other corporations. The rules are complicated, but Buffett figures that his effective tax rate on dividends received is only 13%. That means the aftertax yield on the 9% Salomon preferred is 8%, much better than the aftertax yield on a high-quality bond.

This explains Buffett's fondness for insurance companies. He thinks insurance is a rotten business, and, other things being equal, he'd like never to write another policy. But where else can he get the juicy, uncommitted cash flows and the tax advantages?

It gets even better with the Berkshire convertible bonds. Interest cost on these is fully tax-deductible. The aftertax interest cost is, therefore, around 3.6%. Now he turns around and reinvests in things that yield at least 8% aftertax. Any banker would kill for a spread like that.

His aversion to paying unnecessary taxes explains Buffett's refusal to let Berkshire pay a common dividend; doing so would expose his shareholders to the notorious double taxation of dividends that Congress allows in the name of "fairness." Better he should reinvest the money and give the shareholders the benefit of untaxed appreciation in asset value.

There are wonderful advantages to being Warren Buffett, with his white knight image, his reputation for the golden

touch, but there is the large disadvantage that, once he has pioneered an investment strategy, the homesteaders are close on his heels. As his innovations are copied, the returns narrow. He is forced to find a new frontier.

So it is with the whitemail/convertible preferreds. According to a recent account in the *Wall Street Journal*, Lazard Freres has created a partnership and has already cut deals with Polaroid and Transco Energy Corp. Theodore Forstmann, the leveraged buyout chap, wanted to raise \$3 billion to \$4 billion from pension funds and insurers to do a haircut on the Buffett technique but has since had to lower his expectations.

What will Buffett do for an encore? Buffett won't talk directly about his plans for the future—why make life easier for the imitators? Anyhow, he is the sort of man who never says a word more than absolutely necessary.

Some clues to his future emerge, however, from what he says of what he sees directly ahead for the economy. Buffett expects many of the leveraged buyouts of the last few years to sink. With its ready access to cheap cash, Berkshire will be able to step in and do some leveraging on terms highly favorable to itself. Buffett already has a term for the next stage: UBOS, an unleveraged buyout.

No way, he concedes, can he match the 20% annual returns he has delivered in the past. Berkshire now has about \$5 billion in equity or net asset value, too much to move around easily. But he is convinced 15% returns are doable. To do that Buffett must generate earnings of \$750 million this year. Five years ago \$200 million would have done the trick.

It looks difficult. And it will be difficult. Getting back to Kierkegaard, the past always seems obvious, the future obscure. But Buffett has his certainties. He likes to say: "In the short run the market is a voting machine, but in the long run it's a weighing machine." So you keep cool, hold down the risks and go with what the scale tells you rather than what the trend of the moment says. Anyone who can do that, consistently, his stock is certainly worth a premium to the market. **F**

MANAGERS THINKING ABOUT ACCOUNTING ISSUES
SHOULD NEVER FORGET ONE OF ABRAHAM LINCOLN'S
FAVORITE RIDDLES: HOW MANY LEGS DOES A DOG
HAVE, IF YOU CALL A TAIL A LEG?
THE ANSWER: FOUR, BECAUSE CALLING A TAIL
A LEG DOESN'T MAKE IT A LEG.
—WARREN BUFFETT

Warren Buffett's Idea of Heaven: "I Don't Have To Work With People I Don't Like"

WARREN BUFFETT THIS YEAR MOVES TO THE TOP OF THE FORBES FOUR HUNDRED. HEREIN HE EXPLAINS HOW HE PICKS HIS UNCANNILY SUCCESSFUL INVESTMENTS AND REVEALS WHAT HE PLANS ON DOING WITH ALL THAT LOOT HE HAS ACCUMULATED.

BY ROBERT LENZNER

On the night of Aug. 17 a steady stream of young baseball fans approached a middle-aged businessman wearing a red polo shirt who was sitting near the field at Omaha's Rosenblatt Stadium. Often shyly, always deferentially, they asked him to sign their scorecards. Warren Buffett accommodated them—in such numbers as to almost guarantee the famous financier's signature won't bring premium prices on the autograph market.

Except for the polite autograph seekers, there were no indications that this pale, slightly bulging Omaha native was the richest person in America and an investment genius on a scale that the world rarely sees. There were no fawning retainers or hangers-on, no bodyguards to drive off paparazzi and supplicants. Buffett is 25% owner of the Omaha Royals, minor league affiliate of the Kansas City Royals, and by all appearances that day you would have thought that is all he is. His close friend, Charles Munger, puts it this way: "One of the reasons Warren is so cheerful is that he doesn't have to remember his lines"—meaning that the public Buffett and the private Buffett are the same man.

Except for his company's private plane—more a business tool than a luxury—there is nothing of self-importance about him. He drives his own car, lives in a nondescript house, hardly ever vacations and just last month passed up an invitation from his close friend, former Washington Post chairman Katharine Graham, to dine with President Clinton on Martha's Vineyard. Buffett will travel a long way for good bridge game, but he'll scarcely



bother to cross the street for the sake of rubbing shoulders with celebrities.

"I have in life all I want right here," he says. "I love every day. I mean, I tap dance in here and work with nothing but people I like. I don't have to work with people I don't like." Buffett caps the statement with a typically midwestern cackle.

That's Warren Buffett, living proof that nice guys sometimes do finish first. And we do mean first. FORBES figures Warren Buffett is now the richest person in the U.S.

This folksy, only-in-America character was worth—as FORBES went to press—\$8.3 billion in the form of 42% of his investment company, Berkshire Hathaway, whose shares at \$16,000 each are the highest priced

on the New York Stock Exchange.

Berkshire Hathaway owns 48% of Geico Corp., a big insurance company; 18% of Capital Cities/ABC, Inc.; 11% of Gillette Co.; 8.2% of Federal Home Loan Mortgage Corp.; 12% of Wells Fargo & Co.; about 7% of the Coca-Cola Co.; 15% of the Washington Post Co.; 14% of General Dynamics; 14% of the voting power in Wall Street's Salomon Inc. We could go on, but we won't, except to add the *Buffalo News*, a newspaper he bought for \$32.5 million in 1977 and that now throws off more cash before taxes each year than he paid for it.

With this broadly diversified mix, Buffett has in the current bull market squeezed past Bill Gates—net worth \$6.2 billion—and John Kluge, at \$5.9 billion, to take top spot on The Forbes Four Hundred.

There's an excellent chance he'll stay there for a good while. Most previous holders of the title—Gates, Sam Walton, John Kluge—made their fortunes in a single industry, and their fortunes are tied to that industry. But Buffett's Berkshire Hathaway has spread its investments across a broad range: media, soft drinks, manufacturing, insurance, banking, finance, consumer goods. As long as the economy grows, you can count on his fortune continuing to grow.

It's almost equally certain that when this 63-year-old is called to his reward, he will have set the stage for the biggest charitable foundation ever, one that easily will dwarf the legacies of Rockefeller, Ford and Carnegie. Over the past 23 years Buffett's investments have compounded his wealth at an average annual rate of 29%. He probably can't keep that up. But give him 15%. If he lives another 20 years and does 15%, the Buffett Foundation will have well over \$100 billion. If, as it is quite possible, he lives a good deal longer . . . well, you get the picture.

What would be the first thing most FORBES readers would ask Warren Buffett if they could have a few words with him? Of course: Warren, what do you think of the stock market?

We asked him, but knowing he hates the question, we did it in a slightly roundabout fashion. What would his hero and mentor, Benjamin Graham, say about the stock market today?

Not missing a beat, Buffett shot back with the response Graham gave when he appeared before the 1955 Fulbright hearings in Washington: "Common stocks look high and are high, but they are not as high as they look. And my guess is that he [Graham] would say the same thing today."

That's about the limit of the specific investment advice Buffett is willing to give: high but not too high. We suppose that would translate into brokerese as a "hold" rather than as a "buy."

In dodging the question, Buffett is not just being evasive. Like Graham and the famous British economist and brilliant stock market investor John Maynard Keynes, whose thinking he greatly admires, Buffett believes that all there is to investing is picking good stocks at good prices and staying with them as long as they remain good companies. He doesn't try to time the market or to catch swings as the George Soros and Michael Steinhardts do. Buffett: "Keynes essentially said don't try and figure out what the market is doing. Figure out businesses you understand, and concentrate. Diversification is protection against ignorance, but if you don't feel ignorant, the need for it goes down drastically."

In a wide-ranging series of conversations with FORBES, Buffett expounded on his investment philosophy. His most basic rule is: Don't put too many eggs in your basket and pick them carefully.

Buffett: "I believe every business school graduate should sign an unbreakable contract promising not to make more than 20 major decisions in a lifetime. In a 40-year career you would make a decision every two years."

Buffett points out that he's not prescribing for all investors. Others can make money out of frenetic trading. "It's doing what you understand and what you are psychologically comfortable

with. But I do not deny the genius of a Peter Lynch or a [Michael] Steinhardt."

Technology stocks are definitely not what Buffett feels comfortable with. "Bill Gates is a good friend, and I think he may be the smartest guy I've ever met. But I don't know what those little things do."

Except for a position in Guinness Plc., the international spirits concern, Berkshire owns no foreign stocks—ignoring as usual the latest Wall Street fad. "If I can't make money in a \$4 trillion market [the U.S.], then I shouldn't be in this business. I get \$150 million earnings passthrough from international operations of Gillette and Coca-Cola. That's my international portfolio."

Again, it's staying with what he feels comfortable with. "I wouldn't mind having a very significant percentage of our portfolio in U.K.-domiciled companies or German-domiciled companies, if I thought I understood the companies and their business and liked them well enough. If some guy owns the only newspaper in Hong Kong or Sydney, Australia and it's at the right price, I'm perfectly willing to buy it."

Those papers may be in foreign climes, but they are in a business he well understands. That gets close to the heart of the way Buffett, your quintessential midwesterner, thinks: not in concepts or theories but in intensely practical terms. Buffett doesn't buy stocks; stocks are an abstraction. He buys businesses—or parts of businesses, if the whole thing is not for sale. "I've no desire to try and play some huge trend of a national nature," is the way he puts it.

Buffett's disdain for trends, concepts and the slogans so beloved of Wall Street grows in part from a simple realization that neither he nor any other man can see the future. It also grows from his extreme inner self-confidence: He has not the psychological need for the constant wheeling and dealing, buying and selling that afflicts so many successful business and financial people. When he believes in something, he does not require immediate market upticks to confirm his judgement.

"What I like is economic strength in an area where I understand it and where I think it will last. It's very difficult to think of two companies in the world in important areas that have the presence and acceptance of Coke and Gillette," two of Berkshire Hathaway's core holdings.

Some smart investors like to say they invest in people, not in businesses. Buffett is skeptical. He says, in his wry way: "When a manager with a reputation for brilliance tackles a business with a reputation for bad economics, the reputation of the business remains intact."

It's not that Buffett doesn't think managers matter. He does. "When [Chairman Roberto] Goizueta and [former president Donald] Keough came into [leadership at] Coca-Cola in the 1980s it made a terrific difference," Buffett says. He is a great admirer of Thomas Murphy of Capital Cities/ABC and Carl Reichardt of Wells Fargo, two big Berkshire holdings. But he doesn't invest on people alone. "If you put those same guys to work in a buggy whip company, it wouldn't have made much difference."

That last sentence is a typical Buffettism: He loves to express himself thus in pithy one-liners that are humorous expressions of common sense. Listen to him sum up his case for owning Gillette stock: "It's pleasant to go to bed every night knowing there are 2.5 billion males in the world who have to shave in the morning. A lot of the world is using the same blade King Gillette invented almost 100 years ago. These nations are upscaling the blade. So the dollars spent on Gillette products will go up."

Or how he thinks of himself as investing in businesses rather than in stocks: "Coca-Cola sells 700 million 8-ounce servings a day. Berkshire Hathaway's share is about 50 million."

His credo, though he doesn't call it that, can be expressed in something he told FORBES: "I am a better investor because I am a businessman, and a better businessman because I am an investor." He's saying a great deal in his seemingly cryptic statement: that business and finance are not two separate activities but intimately connected. A good businessman thinks like an investor. A good investor thinks like a businessman.

There's a fine line here, however. Buffett doesn't try to run the businesses he invests in. As he puts it, "The executives regard me as an investing partner. I'm somewhat involved, talking over leadership succession, potential acquisitions and other important matters. Managers know I think about these things and they talk to me."

To keep himself posted he relies very little on the gossip some people think is inside information. He does spend five or six hours a day reading, with lesser periods on the phone. He hates meetings. Berkshire Hathaway's board meets once a year. But Buffett does quite faithfully attend directors meetings at Gillette, Capital Cities/ABC, Salomon Inc., USAir Group and Coca-Cola each month.

While Buffett's character and investing style are all his own, they owe a lot to three influences. "If I were to give credit in terms of how I've done it in investments, my dad would be number one, and Ben Graham would be number two. Charlie Munger would be number three."

He credits his father, Howard Buffett, a stockbroker and one-time congressman, with setting an example of how to behave. "He taught me to do nothing that could be put on the front page of a newspaper. I have never known a better human being than my dad."

He credits Graham with giving him "an intellectual framework for investing and a temperamental model, the ability to stand back and not be influenced by a crowd, not be fearful if stocks go down." He sums up Graham's teaching: "When proper temperament joins with proper intellectual framework, then you get rational behavior."

Charles Munger is Buffett's sidekick, vice chairman of Berkshire Hathaway and, after Buffett and his wife, its largest shareholder, with 1.8% of the stock. He lives in Los Angeles, but he and Buffett are on the phone almost daily. "Charlie made me focus on the merits of a great business with tremendously growing earning power, but only when you can be sure of it—not like Texas Instruments or Polaroid, where the earning power

was hypothetical. Charlie is rational, very rational. He doesn't have his ego wrapped up in the business the way I do, but he understands it perfectly. Essentially we have never had an argument, though occasional disagreements."

Disagreements? Munger says that there are times when he has to prod Buffett away from his old Ben Graham attitudes about what constitutes a bargain. Munger: "Warren was a little slower to realize that a very great business can sell for less than it's worth. After all, Warren worshipped Ben Graham, who waited to buy companies at a fraction of the liquidation value, and it's hard to go beyond your mentor. Sure, I convinced him we should pay up for good businesses."

Today Buffett realizes that "when you find a really good business run by first-class people, chances are a price that looks high isn't high. The combination is rare enough, it's worth a pretty good price." In almost every instance that pretty good price gets even better after he buys the stock. Coca-Cola is a prime example.

One thing Munger doesn't have to twist Buffett's arm on: They both believe you should never sell those great businesses as long as they stay great, almost regardless of how high the stock price gets. What would be the point? You would have to reinvest the money in something less great. As Omar Khayyam put it, and Munger/Buffett would certainly agree: "I often wonder what the Vintners buy half so precious as the stuff they sell."

Buffett says he is permanently attached to this three vintage media holdings, the Washington Post, Capital Cities/ABC and the Buffalo News. He analyzes these holdings: "Television networks are a business that's tougher but still very good with very good management. It generates a lot of cash. The Washington Post is a terribly strong newspaper property run by high-class people. Don [Graham], the new chairman, will be an excellent leader. It's one of the great stories of generations succeeding—three 7s in a row."

He'll never sell the lucrative Buffalo News. Aren't newspapers becoming obsolete? Buffett: "I don't think they're technically obsolete, but I don't think it's as good a business as it used to be."

Buffett has received FTC permission to raise his stake in Salomon Inc. from 14% to 25%, even though Salomon shares have already more than doubled since its Treasury bond scandal. Why did he wait so long to increase his stake? He felt it wasn't fair to buy more shares when he was involved in turning the company around.

Are great investor/businessmen like Buffett made or born? In this case the verdict would have to be the genetic one. As a kid he traded on a small scale, buying Coca-Cola from his grandfather's store and reselling it to neighbors. When he was 20 and a student at Columbia University, he started studying the insurance industry. His hero and professor, Benjamin Graham, was chairman of Geico, Government Employees Insurance Co., based in Washington, D.C. Wanting to know more about a company Graham had invested in, one Saturday Buffett paid a cold call on Geico, and was treated to a five-hour sermon by Lorimer Davidson, then vice president of finance, on how the insurance business worked.

Buffett then had about \$ 9,800 in capital. He proceeded to invest three-quarters of it in Geico stock. "It was a company selling insurance at prices well below all the standard companies, and making 15% profit margins. It had an underwriting cost than of 13% or so, whereas the standard companies had probably 30%-to-35% cost. It was a company with a huge competitive advantage, managed by the guy that was my God."

In those days Buffett was devouring financial tomes the way most people his age consumed the sports pages or mystery novels. While working for his father's brokerage firm in Omaha, he would go to Lincoln, Nebr., the state capital, and read through the convention reports, or statistical histories of insurance companies. "I read from page to page. I didn't read brokers' reports or anything. I just looked at raw data. And I would get all excited about these things. I'd find Kansas City Life at three times earnings, Western insurance Securities at one times earnings. I never had enough money and I didn't like to borrow money. So I sold something too soon to buy something else."

Jumping back to the present for a moment, he comments: "I was overstimulated in the early days. I'm understimulated now." Stock prices are many times higher now, and when you have billions to invest rather than thousands there's a lot less around to stimulate you.

Even though his lack of capital sometimes led him to sell too soon, Buffett prospered. Geico and Western Insurance Securities were huge winners.

In the early days of his career he followed Graham's quantitative guidelines obsessively. Graham figured you couldn't lose and would probably gain if you bought a stock for less than the value of its working capital alone. "I bought into an anthracite company. I bought into a windmill company. I bought into a street railway company, or more than one." But these cheap stocks were cheap for a reason; the businesses were dying.

Buffett soon realized that instead of seeking sure-thing statistical bargains, he would have to find companies that were undervalued for reasons that might not appear on the balance sheet—things like valuable brand names or strong market positions. As a professional money manager he began to make spectacular returns for his clients, with killings in such stocks as American Express and Disney.

But in 1969 he took down his shingle, returned his partners' money and concentrated on his own investments. In retrospect the timing was brilliant. The first post-World War II bull market had essentially ended, though few people realized it. Although a handful of stocks continued to rise until 1973 and 1974, the bull was exhausted.

Aha! So Buffett really is a market timer? No, he says. He simply couldn't find any stocks he wanted to buy at those prices. If it comes to the same thing either way, you can see that Buffett thinks in terms of companies, not in terms of markets. "I felt like an oversexed guy on a desert island," he quips, "I couldn't find anything to buy."

But after the crash of 1974, which took the DJI down nearly 50% from its previous high, he had plenty of stimulation in his search for bargains. Reversing the quip, in November 1974 he told FORBES he felt "like an oversexed guy in a harem."

In the mid-1960s he had bought control of a down-at-the-heels textile operation in New Bedford, Mass. It looked cheap in that he paid less than the book value of the assets. Only it turned out those assets weren't worth what the books said they were. Says Buffett: "I thought it was a so-so textile business, but it was a terrible business."

Yet, ever the opportunist, Buffett used the base as a vehicle for slaking his passion for stocks in a market where the Dow Jones industrial average was well below 1000. Of Berkshire Hathaway he says: "We worked our way out of it by growing the other capital, but in the late 60s half our capital was in a lousy business, and that is not smart."

Gradually Buffett moved away from pure Ben Graham to modified Ben Graham. It was then that he made his fat payoff investments in companies like the Washington Post that were then undervalued, not because they had lots of cash and physical assets but because they had valuable franchises that were not recognized by the market. He describes the change in parameters: "Ben Graham wanted everything to be a quantitative bargain. I want it to be a quantitative bargain in terms of future streams of cash. My guess is the last big time to do it Ben's way was in '73 or '74, when you could have done it quite easily."

Is Warren Buffett infallible? No way. He readily concedes he left \$2 billion on the table by getting out of Fannie Mae too early. He didn't buy as much as he set out to and sold too early.

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Why? He shakes his head. “It was easy to analyze. It was within my circle of competence. And for one reason or another, I quit. I wish I could give you a good answer.”

He also sold part of Berkshire’s position in Affiliated Publications, the owner of the *Boston Globe* newspaper, because he did not fully grasp the value of Affiliated’s big position in McCaw Cellular. He is less miffed about this mistake than about the FNMA one. “I missed the play in cellular because cellular is outside of my circle of competence.”

What does Buffett think of politics? Buffett was a registered Republican, like his father, but he switched parties in the early 1960s. “I became a Democrat basically because I felt the Democrats were closer by a considerable margin to what I felt in the early 60s about civil rights. I don’t vote the party line. But I probably vote for more Democrats than Republicans.”

If Buffett is a bit cagey about his politics, he isn’t cagey in expressing his opinion about some U.S. corporate management. “If you have mediocrity and you have a bunch of friends on the board, it’s certainly not the kind of test you put a football team through. If the coach of a football team puts 11 lousy guys out on the field, he loses his job. The board never loses their job because they’ve got a mediocre CEO. So you’ve got none of that self-cleansing type of operation that works with all the other jobs.”

There’s a general impression that Buffett plans to cut off his three children, forcing them to fend for themselves. Nonsense, he says. “They’ve gotten gifts right along, but they’re not going to live the life of the superrich. I think they probably feel pretty good about how they’ve been brought up. They all function well, and they are all independent, in that they don’t feel obliged to kowtow to me in any way.” He puts modest amounts each year in the Sherwood Foundation, which is used by his children to give money away in Omaha. Another family foundation gives \$4 million a year to support programs promoting population control.

Beyond that, Buffett has sometimes been criticized for not giving away bigger chunks of his great fortune—even when pressed by friends and associates. He explains: “I wouldn’t want to transfer Berkshire Hathaway shares to anyone while I’m alive.

If I owned a wide portfolio of securities I could give them away. But I don’t want to give up control of Berkshire Hathaway.”

But when death does force his hand, his legacy is going to be a whopper. He plans to leave 100% of his Berkshire Hathaway holding to his separated but not estranged wife, Susan. He has no written contract with Susan that the shares will go into a foundation, but that is the understanding between them. Says he: “She has the same values I do.” The deal is whoever dies last will leave the Berkshire Hathaway shares to a foundation with no strings attached.

Buffett: “I’ve got this fund that’s not yet activated, and it is building at a rate greater than other endowments, like Harvard’s. It’s growing at a rate of 25% to 30%.

“When I am dead, I assume there’ll still be serious problems of a social nature as there are now. Society will get a greater benefit from my money later than if I do it now.” Any hints as to where he’d like to see the money go? Control of nuclear proliferation is very much on his mind. “Who knows how many psychotics in the world will have the ability to do something with nuclear knowledge that could wreak havoc on the rest of the world?”

It’s a little hard to see how money can deal with that problem, but Buffett points out that money could do a lot for what he regards as another major problem: excessive population growth.

“I have got a very few superhigh-grade, very intelligent people in charge of deciding how to spend the money. They [will] have total authority. There are no restrictions. And all they are supposed to do is use it as a smart high-grade person would do under the circumstances that exist when it comes into play, which I hope is not soon.”

The trustees of his will include his wife, Susan, his daughter Susan, his son Peter, Tom Murphy, chairman of Capital Cities/ABC and *Fortune*’s Carol Loomis.

It’s very much in harmony with his pragmatic nature that Buffett plans on putting few strings on the money. Just so long as they don’t turn it into a conventional bureaucratic foundation. “If they build an edifice and become traditional I’ll come back to haunt them,” he declares. **F**

**SHOULD YOU FIND YOURSELF IN A
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ENERGY DEVOTED TO CHANGING
VESSELS IS LIKELY TO BE MORE
PRODUCTIVE THAN ENERGY
DEVOTED TO PATCHING LEAKS.**

The Not-So-Silent Partner

MEET CHARLIE MUNGER, THE LOS ANGELES LAWYER WHO CONVERTED WARREN BUFFETT FROM AN OLD-FASHIONED GRAHAM VALUE INVESTOR TO THE ULTIMATE BUY-AND-HOLD VALUE STRATEGIST.

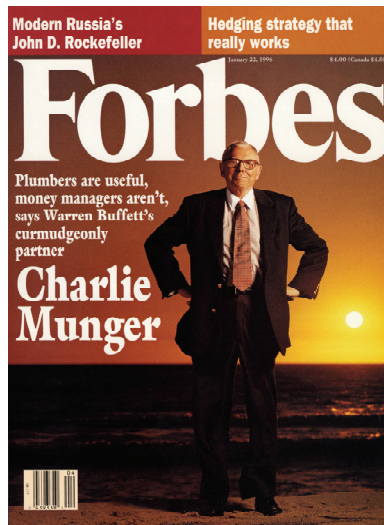
BY ROBERT LENZNER AND DAVID S. FONDILLER

Warren Buffett, probably the greatest investor in modern American history, did not do it alone. He never claimed he did, but so overwhelming has his public presence become that few people realize that for more than 30 years Buffett has had a not-so-silent partner who is as much the creator of the Berkshire Hathaway investment philosophy as is the master himself.

Charles Munger is a 72-year-old lawyer and investor, a curmudgeon who lives in Los Angeles, 1,300 miles and a two-hour time difference from Buffett's headquarters in Omaha, Nebr. Munger and Buffett complement each other beautifully. Munger comes on more arrogant and erudite, while Buffett comes on modest and folksy. But that's the surface in both cases. Underneath these are two minds in almost uncanny sync.

"I probably haven't talked to anyone on Wall Street one hundredth of the times I speak to Charlie," says Buffett. Charles Munger is the quintessential realist against whom Buffett tests his ideas. "Charlie has the best 30-second mind in the world. He goes from A to Z in one move. He sees the essence of everything before you even finish the sentence." In 1978 Munger was named vice chairman of Berkshire Hathaway and in 1983 chairman of Wesco Financial Corp., a finance company that's 80% controlled by Berkshire. He is also a director of Salomon Inc.

To understand Munger's influence on Buffett you have to recall the gradual evolution of the latter's investment philosophy. The Omaha phenomenon began as pure Ben Graham—buy cheap stocks at giveaway prices if possible and sell them when they are cheap by careful balance sheet analysis. Buffett still follows the Graham precepts of careful analysis, but it's been years since Buffett has bought stocks that, by Graham's standards,



are cheap in terms of assets, earnings or cash flow. Nor does he, in classic Graham style, look to sell holdings when they catch up with the market.

Over the years, especially in the 1980s and 1990s, Buffett has moved closer to the concept of one-decision growth stocks—buy 'em and hold 'em forever, or at least until their fundamentals deteriorate.

Coca-Cola wasn't cheap by conventional standards when Berkshire Hathaway first bought it in 1988. On *The Street* it was regarded as an excellent but fully valued stock. Coca-Cola has since appreciated by close to 600%, or a compound annual rate of return of some 25%, but Berkshire has taken not a penny in profits and has sold

not a single share.

What distinguishes Buffett and Munger from the herd that went to its doom in 1974 with the Nifty 50 one-decision growth stocks in this: In true Ben Graham fashion Buffett and Munger do their homework. Berkshire Hathaway's one-decision picks—Coca-Cola, Washington Post Co., Geico, Gillette, Wells Fargo, Buffalo News and Dexter Shoes—were chosen only after exhaustive analysis of balance sheets and of social and economic trends. Where most analysts saw only good but fully valued properties, Buffett saw franchises that were priceless, virtually immune from inflation and capable of continued growth—compound interest machines, in short. None of the flashes in the pan here like Avon Products or Xerox that passed as buy-and-hold-for-ever stocks 20 years back.

In that gradual synthesis of Graham and one-decision theory, Charlie Munger played the creative role. Buffett says: "Charlie shoved me in the direction of not just buying bargains, as Ben Graham had taught me. This was the real impact he had on me. It took a powerful force to move me on from Graham's limiting views. It was the power of Charlie's mind. He expanded

my horizons.”

As if completing Buffett's thought—though in a separate interview—Munger explains further: “We realized that some company that was selling at two or three times book value could still be a hell of a bargain because of momentums implicit in its position, sometimes combined with an unusual managerial skill plainly present in some individual or other, or some system or other.”

Coca-Cola fits that pattern. So do See's Candies and the Washington Post Co. Munger says: “We intend to hold Coca-Cola forever.” Forever? That's a word not to be found in Ben Graham's investment lexicon.

Conventional wisdom says that no one ever went broke taking profits. Munger doesn't think that way. “There are huge advantages for an individual to get into a position where you make a few great investments and just sit back. You're paying less to brokers. You're listening to less nonsense.”

Best of all, Munger says, you don't have to pay off the tax collector every year. “If it works, the governmental tax system gives you an extra one, two or three percentage points per annum with compound effects.” Munger is referring to what most investors know in theory but ignore in practice: that the so-called capital gains tax is no capital gains tax at all. It is a transaction tax. No transaction, no tax. Since profit-taking involves transactions it obliges you to take the IRS in as a partner. With profits not taken, there remains a theoretical tax liability, but the money is still working for you.

Besides, if you sell stock in a great company, where can you find a comparable investment? As the poet Omar Khayyam put it: “Oft I wonder what the vintner buys half so precious as the stuff he sells.”

Buffett and Munger share a deep respect for the awesome, mysterious power of compound interest. Charlie Munger loves to quote his hero, Benjamin Franklin, on the subject. Wrote Franklin of compounding: “... 'tis the stone that will turn all your lead into gold ... Remember that money is of a prolific generating nature. Money can beget money, and its offspring can beget more.”

Munger is rarely without a compound rate of return table. He illustrates its magic by taking an investment of \$1 and demonstrating that a return of 13.4% a year, after taxes, over 30 years, will make that \$1 worth \$43.50. To Munger it's much better to depend on compounding than on market timing.

What few people realize is that Buffett and Munger wring extra power from the compounding principle through use of leverage. Take that \$1 compounded for 30 years at 13.4%. Suppose in the first year you borrow 50 cents at 8% and invest that, too. The net effect is to raise your rate of return from 13.4% to 18.8%. Repeat that process every year, and over the full 30 years your \$1 will beget its way to \$176.

“Understanding both the power of compound return and the difficulty getting it is the heart and soul of understanding a lot of things,” says Munger in typically grandiose terms.

Munger persuaded Buffett to buy 100% of See's Candies for Berkshire in 1972 for \$25 million, net of surplus cash. This was no Ben Graham stock. But it has turned out to be a compound interest machine. Last year See's made about \$50 million pretax, putting a value on the company of \$500 million. That's a 13.3% compounded rate of return for 24 years. Add in pretax retained earnings over this period—which were reinvested—and you get a total pretax return of over 23% annually.

At any time in these 24 years Berkshire Hathaway could have cashed in all or part of See's through an initial public offering. Why didn't it? Answers Munger: “The number of acquisitions making 23% pretax is very small in America.” Better to leave the money compounding in a relatively sure thing.

In Roger Lowenstein's insightful and highly readable biography, *Buffett: The Making of an American Capitalist*, Munger gets relatively few pages of his own. Yet Buffett would be the first to admit that without Charles Munger he probably would not have become one of the richest men in the world.

Lowenstein doesn't ignore Munger's role but, perhaps because it is less dramatic than Buffett's, he underplays it. Once a year Warren and Charlie sit side-by-side on the stage of an auditorium in Omaha on the day of the Berkshire Hathaway annual meeting. They often meet in New York and California, and recently spent the weekend in Seattle with Buffett's close pal, Microsoft's Bill Gates. But for most of the year they are connected only by the telephone wires.

In the exchanges carried over those wires, Buffett is the stock picker while Munger is the doubter, the skeptic, the devil's advocate, against whom Buffett tests his ideas. The simple fact is that you can't tell whether an idea is likely to work unless you consider all the possible negatives. Not that Munger is a sourpuss. Their verbal exchanges are larded with jokes. For all their surface differences, these two men have similar minds. “Everybody engaged in complicated work needs colleagues,” explains Munger. “Just the discipline of having to put your thoughts in order with somebody else is a very useful thing.”

“You know this cliché that opposites attract? Well, opposites don't attract. Psychological experiments prove that it's people who are alike that are attracted to each other. Our minds work in very much the same way.”

Where and how do their minds work together? “On the close calls,” Munger replies. Okay, it's a good company. But is the price low enough? Is the management made up of people Munger and Buffett are comfortable with? If it is cheap enough to buy, is it cheap for the wrong reason or the right reason? As Munger puts it: “What's the flip side, what can go wrong that I haven't seen?”

Right now the two men are matching wits about Berkshire Hathaway's 20 million shares, or 13% stake, in Capital Cities/ABC worth \$2.5 billion. By early this year, when shareholders vote on the takeover of Capital Cities by Walt Disney Co., Munger and Buffett will have to

decide whether they want to become one of the two largest shareholders in what would be the biggest entertainment concern in the nation.

Should they go for all Walt Disney stock in the deal? Or compromise by choosing half stock and half cash? Maybe with the Dow over 5000, they should cash in all their chips.

Don't be surprised if Buffett and Munger go for a good-sized chunk of cash. "We have huge admiration for what Disney has achieved. But the stock is very high, and the market itself is near record levels," Munger tells FORBES. Disney is selling at 22 times earnings and 5 times book value. It's good, but is it that good? Munger and Buffett are keeping the wires burning talking about it.

In a tie vote, Munger says, Buffett wins. After they have kicked around a subject, he is willing to let Buffett make the final decision. "A lot of dominant personalities, like me, can never play the subservient role even to Warren, who is more able and dedicated than I am," Munger says.

That last sentence explains a lot about both men. Munger is immensely opinionated. Yet he is willing to play second fiddle. To subordinate strong views and a powerful personality requires a high degree of self-discipline and objectivity. Objectivity is the key word here. It means stripping decisions of emotions, of hopes and fears, of impatience and self-delusion and all purely subjective elements. Few people have this strength. Munger does. Giving in sometimes to Buffett requires, in Munger's own words, "objectivity about where you rank in the scheme of things."

Another word for objectivity is "coldblooded." Most of us mere humans get dizzy when a stock we hold goes up and up. Acrophobia sets in. We fear losing our paper profits. So we sell and sometimes we are sorry. At the other extreme, we like an investment but shy away because the consensus says we are wrong. Munger and Buffett strive to strip out emotion. Likewise, when things start to go wrong, most of us keep hoping they will soon get better. Munger and Buffett try not to hope but to coldly analyze the possibilities. This hard-nosed objectivity had a recent demonstration in the joint decision to redeem \$140 million worth of preferred shares in troubled Salomon Inc. rather than convert them into common shares. Emotionally, Buffett and Munger had a lot tied up in Salomon. Objectively, they could find better places to put the money. Salomon just had to go.

Munger backed up Buffett on one of the most cold-blooded decisions at Salomon: to refuse to pay all of the deferred and vested compensation former chairman John Gutfreund claimed he was owed. Contrast this with the rich payoffs recently given to ousted executives at Time Warner. In Munger's view, Gutfreund let the company down and deserved no huge golden handshake.

Gutfreund is bitter toward Munger. For the sake of keeping the peace most executives would have paid Gutfreund off. But in Munger's view that would not be an objective decision.

More often than they disagree, Munger and Buffett see things

exactly alike. It took them only about three hours to decide about accumulating a 4% position in the Federal Home Loan Mortgage Corp. for Berkshire Hathaway in 1989. That position, for which Berkshire paid only \$72 million, is today worth over half a billion dollars.

It was a no-brainer, says Munger. "Only savings and loans could own it. And nobody could own more than 4%. Here was the perfect inefficient market. You've got some thing that makes hundreds of millions of dollars. It was obvious."

For Buffett and Munger maybe. But not for everyone.

Buffett is by far the wealthier of the two. Buffett—who got there first—with his wife owns 43.8% of Berkshire Hathaway, worth \$17 billion. Munger's 1.6% is currently worth \$610 million.

Where Buffett says he can't remember ever selling a share of Berkshire stock, Munger has given away several hundred shares as charitable gifts. He has given heaps of money to Los Angeles' Good Samaritan Hospital. He has contributed liberally to Planned Parenthood and the Stanford University Law School, and was the major donor of a new science center at the Harvard-Westlake School, a private day school in Los Angeles.

It's not a question of relative greed: Buffett does not live an especially lavish life and plans on leaving almost everything to his wife, Susan, who in turn has promised to leave it to the best endowed foundation in the world. It's as if the two men, on this point, have different time spans: Munger wants the satisfaction of seeing his money do good things now; Buffett sees his role as piling up more chips for his heirs to do good things with.

Apparently Buffett figures that the longer he has to work his compound interest magic, the more money his heirs will have to do good with. While a lot of people criticize Buffett for not being more generous, Munger stoutly defends his friend: "It's more useful for Warren to be piling it up than to be giving it away." It was Munger, not Buffett, who initiated the designated contributions plan under which Berkshire shareholders get to donate \$13 for each of their shares to their favorite charity.

One thing on which Munger and Buffett do not exactly agree is politics. Munger who, with his second wife, Nancy, has eight children, is a registered Republican. Buffett is a Democrat who has enjoyed rubbing elbows with the Clintons. "I'm more conservative, but I'm not a typical Colonel Blimp," says Munger.

While he has less passion than Buffett for civil rights, Munger does agree with Buffett on population control and abortion rights. During the 1960s Munger helped California women obtain abortions in Mexico by paying for their trips. Later he was a driving force in helping persuade the California Supreme Court to make the first decision overturning, on constitutional grounds, a law prohibiting abortions. Recalls Buffett: "Charlie took over the case. He solicited the deans of leading medical and law schools to enter amicus briefs. Charlie did all the work on it night and day, even writing some of the briefs himself."

There must be some thing in the air or the water in Omaha. Though the pair met only in the late 1950s, the house Munger grew up in is only 200 yards from Buffett's current home. As a

young man Munger also worked in Buffett's grandfather's grocery store. After attending the University of Michigan and the California Institute of Technology without getting a degree, Munger served as meteorological officer in the Air Force in World War II. He gained entrance to Harvard Law School without an undergraduate degree, and graduated in 1948.

He was only 22 when he entered Harvard, but even by the standards of that arrogant institution Munger was noted as a brainy but somewhat pompous and conceited fellow. Unprepared for a lesson one day, he calmly told his professor, "Give me the facts and I'll give you the law."

Unlike Buffett, Munger has never devoted full time to investing. After graduation he shunned his hometown, plying for the richer prospects in Los Angeles where he joined Musick Peeler & Garrett, the law firm that represented wealthy local entrepreneurs, including J. Paul Getty.

Later Munger formed his own firm, Munger, Tolles & Olson, which still carries his name first. It is one of the leading California firms, representing Southern California Edison and Unocal, as well as Berkshire Hathaway. In 1965 he stepped down as an active partner of the firm, though he keeps his office there and still lectures the partners on the importance of choosing clients like friends, and not going for the last dollar.

Munger began his investment career independent of Buffett. From 1962 until 1975 he managed Wheeler Munger & Co., an investment counseling firm, from a grungy office in the Pacific Coast Stock Exchange building. Munger's investment record did not match Buffett's in those years, but he earned a highly respectable compound return of 19.8% a year before fees and after expenses.

Munger did not become a large Berkshire Hathaway shareholder until the late 1970s when two of his holdings, Diversified Retailing, and later Blue Chip Stamps, were merged into Berkshire. After that Buffett and Munger got to know each other better—and Buffett moved into his most productive period.

The two live very different lives. Of late Buffett has begun to enjoy his popularity, while not neglecting his investing. Munger, as always, pursues a wide range of activities. "I've tried to imitate, in a poor way, the life of Benjamin Franklin. When he was 42, Franklin quit business to focus more on being a writer, statesman, philanthropist, inventor and scientist. That's why I have diverted my interest away from business."

Remarkably, neither Munger nor Buffett has much regard for Wall Street, though it has made their fortunes. "On a net

basis the whole investment management business together gives no value added to all stock portfolio owners combined," Munger says. "That isn't true of plumbing and it isn't true of medicine. Warren agrees with me 100%. We shake our heads at the brains that have been going into money management. What a waste of talent."

Munger likens the market to the racetrack, where it's notoriously hard to beat the odds because the track takes a 17% cut on each dollar bet. Add in commissions, management charges, underwriting profits and the whole fee structure, and the financial community's take, while less than that of a racetrack, can still be quite material.

"Beating the market averages, after paying substantial costs and fees, is an against-the-odds game; yet a few people can do it, particularly those who view it as a game full of craziness with an occasional mispriced something or other," Munger says.

He adds: "Personally, I think that if security trading in America were to go down by 80%, the civilization would work better. And if I were God, I'd change the tax rules so it would go down by 80%—in fact, by more than 80%." Munger once proposed a 100% tax on gains taken in less than a year from securities trading.

Is there a contradiction between this disdain for professional investing and Buffett and Munger's brilliant practice of the art? You can tell by his answer that Munger has given a great deal of thought to that question.

"I join John Maynard Keynes in characterizing investment management as a low calling," he responds, "because most of it is just shifting around a perpetual universe of common stocks. The people doing it just cancel each other out. You will note that none of my children is in investment management. Warren and I are a little different, in that we actually run businesses and allocate capital to them.

"Keynes atoned for his 'sins' by making money for his college and serving his nation. I do my outside activities to atone and Warren uses his investment success to be a great teacher. And we love to make money for the people who trusted us early on, when we were young and poor."

In FORBES' view, the social conscience Munger expresses is part and parcel of his investment success, as is Buffett's. And so these complex, aging prodigies carefully tend their compound interest machine, a joint creation of two exceptional personalities. Others may try to duplicate Berkshire Hathaway, but they won't be able to duplicate these two exceptional minds. **F**

IT'S BETTER TO HANG OUT WITH PEOPLE BETTER THAN YOU. PICK OUT ASSOCIATES WHOSE BEHAVIOR IS BETTER THAN YOURS AND YOU'LL DRIFT IN THAT DIRECTION.

Buffett On Bridge

AS THE DUKE OF WELLINGTON TRAINED ON THE PLAYING FIELDS OF ETON, WARREN BUFFETT TRAINS AT THE BRIDGE TABLE.

BY ALEXANDRA ALGER



My virtual bridge game with Warren Buffett is off to a bad start. My partner is Sharon Osberg, Buffett's regular partner and a Wells Fargo senior vice president. Buffett is teamed up with his old friend Charlie Graham, who used to run a Buick dealership in Omaha.

This being an Internet game, we're all sitting in our own homes, in front of computers—I in New York, Osberg in San Francisco, Buffett in Omaha and Graham in San Diego.

Osberg and Buffett each type in a message to me. A bidding box appears on my computer screen, blocking their words. Click, click. I can't get my mouse to move that box! Click, click. "Wait," I type. "I can't see what you're saying, the bidding box is in the way."

My husband, in disgust, wrenches the mouse from me

and moves the box. "I won't chronicle this in next year's annual report," Buffett jokes, trying to put me at my ease.

It's 9:30 p.m. EST on a recent Thursday night, and we are one of 125 foursomes at OKbridge, a virtual bridge club. Buffett, a.k.a. tbone—his log-on name and favorite food—is a regular. Pick any night of the week, and odds are tbone's here, with friends from all over the U.S.

Buffett's been a bridge fan almost as long as he's been a stock market player. He learned the game while at the University of Pennsylvania in the 1940s. But thanks to the Internet, he's now an addict, logging 12 hours a week on OKbridge without even leaving his home. Seeing Buffett's obsession, his friend Bill Gates has tried to limit his own enthusiasm for the game. Buffett explains: "He doesn't want to get addicted, so he only plays with me."

Buffett and sidekick Charlie Munger once took on Gates and Sharon Osberg at Gates' place. They started around noon. "Seven hours later dinner guests were knocking at the door, but Bill wanted to keep playing" Buffett recalls.

What is it about bridge that fascinates brainy people like Buffett and Gates? Fifty years ago no one would have had to ask. Bridge was a national pastime. But today, according to U.S. Playing Card Co., while 40% of American households play cards, only 2% play bridge. Most bridge addicts are old enough to be grandparents. At the American Contract Bridge League, the median member is 66 — exactly Buffett's age.

Maybe there are too many distractions today. Maybe young Americans lack the attention span. At any rate, Buffett thinks they are missing out. "It's got to be the best intellectual exercise out there," he says. "You're seeing through new situations every ten minutes."

Bridge is a highly cerebral game—the luck of the draw is much less important than how you play what you draw. You must make decisions based on necessarily vague signals from your partner, from fragmentary evidence and from a disciplined memory for the cards already played.

Sophisticated players recognize bridge as a game of probability—like the stock market. To win you have to figure out the location of the cards you don't have. (Any big market player will recognize the parallels.) "It's a game of a million inferences," Buffett explains. "There are a lot of things to draw inferences from—cards played and cards not played. These inferences tell you something about the probabilities."

To play bridge well consistently you have to play with the odds, which involves shrewd guessing. "In the stock market you don't base your decisions on what the markets are doing, but on what you think is rational," Buffett says. "In bridge, too, if you always do the rational thing, you'll be a winner over time, though not necessarily that night."

He adds: "Bridge is about weighing gain/loss ratios. You're doing calculations all the time. It's also a partnership game. You can mess up your partner or bring out the best in him. You can't win alone."

You'd think a guy like Buffett, who as a child could spout the populations of U.S. cities, would be a bridge whiz. In fact his enthusiasm outruns his talent here, and he is modest enough to admit it. "In business you don't have to do extraordinary things to get extraordinary results," he says. "You have to have a sound approach, but you don't have to be brilliant. But you have to have some special gifts at bridge to be at the

very top. You have to have an extremely good memory for cards, and an ability to draw inferences.

"If you play with someone like Bob Hamman [the top-ranked bridge player in the world] they can look like they're having a drink or eating a sandwich, but they'll know everything that's going on."

If people like Buffett feel humble playing against the Hammans of this world, imagine how I felt matched against Buffett and partnered with Sharon Osberg. She is a two-time world bridge champion. And she's the one who got Buffett — famous for saying he'd never need a computer—to buy an IBM PC so they could play together regularly.

If only Osberg could help me bid. I sit staring at my first hand. Bids start to appear on my monitor. How do they make decisions so quickly? Osberg bids hearts and ends up winning the hand for us. Tbone and Graham win the next.

"You would've beaten us if Sharon had had six spades instead of five," reads a message from tbone.

"How'd you know she had five?" I ask. "Because she bid spades," comes the typed reply.

It's one of the most basic rules in bridge: To open bidding in spades or hearts, you should have at least five of that suit. "Bidding or lack of bidding always means something," he notes.

Finally I have a really good hand. Osberg and I are on the offensive, having bid three hearts. We're going to try for 9 out of the 13 tricks. Feeling confident, I play a few cards very quickly. "You don't get points for speed," tbone types. "Don't make a move until you know what the next move is going to be. S.J. Simon, chapter two." The reference is to Buffett's favorite bridge book, *Why You Lose at Bridge*, a 1946 classic that's still in print.

Sure enough, I'm hurt by my quick moves. We win but only just. Graham won one trick with a jack I didn't know he had. Better players keep count of what high cards haven't been played—I'd lost track.

"It takes a while to get the hang of it, but that's what makes it such a terrific game," tbone writes. "There are always new levels."

Will getting better at bridge make me better at picking investments? "No," comes Buffett's reply. "But the better you understand the game the more fun it is." **F**

OF THE BILLIONAIRES I HAVE KNOWN, MONEY JUST BRINGS OUT THE BASIC TRAITS IN THEM. IF THEY WERE JERKS BEFORE THEY HAD MONEY, THEY ARE SIMPLY JERKS WITH A BILLION DOLLARS.

The Berkshire Bunch

CHANCE MEETINGS WITH AN OBSCURE YOUNG INVESTMENT COUNSELOR MADE A LOT OF PEOPLE WILDLY RICH. WITHOUT KNOWING IT, THEY WERE BUYING INTO THE GREATEST COMPOUND-INTEREST MACHINE EVER BUILT.

BY DOLLY SETTON AND ROBERT LENZNER

In 1952 a 21-year-old aspiring money manager placed a small ad in an Omaha newspaper inviting people to attend a class on investing. He figured it would be a way to accustom himself to appearing before audiences. To prepare he even spent \$100 for a Dale Carnegie course on public speaking.

Five years later Dr. Carol Angle, a young pediatrician, signed up for the class. She had heard somewhere that the instructor was a bright kid, and she wanted to hear what he had to say. Only some 20 others showed up that day in 1957.

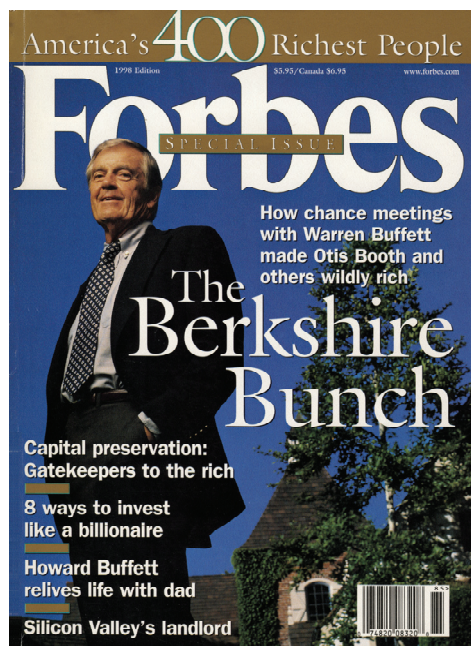
You will by now have guessed the teacher's name: Buffett. Warren Buffett.

"Warren had us calculate how money would grow, using a slide rule," Dr. Angle, now 71, recalls. "He brainwashed us to truly believe in our heart of hearts in the miracle of compound interest."

Persuaded, she and her husband, William, also a doctor, invited 11 other doctors to a dinner to meet young Warren.

Buffett remembers Bill Angle getting up at the end of the dinner and announcing: "I'm putting \$10,000 in. The rest of you should, too." They did. Later Carol Angle increased her ante to \$30,000. That was half of the Angles' life savings.

Dr. Angle still practices medicine, as director of clinical toxicology at the University of Nebraska Medical Center. But she doesn't work for the money. Her family's holdings in Buffett's Berkshire Hathaway have multiplied into a fortune of



\$300 million.

Carol Angle is a charter member of the Berkshire Bunch, a diverse tribe scattered throughout the land whose early faith in Warren Buffett has led to immense riches.

In Omaha alone there may be at least 30 families with \$100 million or more worth of Berkshire stock, according to George Morgan, a broker at Kirkpatrick Pettis who handles accounts of many Berkshire holders.

Mildred and Donald Othmer died recently, leaving an estate almost entirely in Berkshire Hathaway stock

worth close to \$800 million. Mildred's mother was a friend of Buffett's family. When Mildred married in the 1950s she and her husband each invested \$25,000 in a Buffett partnership.

That was before Buffett had accumulated enough money to buy control of a struggling old New England manufacturer of textiles, handkerchiefs and suit linings called Berkshire Hathaway. At the time his first converts signed on, Buffett was running essentially what we would today call a private investment partnership. When he disbanded the partnership in 1969, explaining that bargains were then hard to find, he returned most of the investors' money and their pro rata Berkshire shares. He recommended to some of his investors that they turn their money over to the smallish Wall Street firm Ruane, Cunniff & Co. and its Sequoia Fund—a recommendation that neither he nor they have reason to regret.

For a while he tried running Berkshire as a textile company, with investments on the side. In the end he liquidated

the business and concentrated entirely on investments. The ebullient stock market of the mid- and late 1960s had turned Buffett off, but things were changing. The overpriced markets of the late 1960s collapsed amid recession, oil crises and inflation, and stocks became cheap again. Speaking to FORBES in late 1974, Buffett proclaimed that stocks were irresistible bargains. (Actually he put it more colorfully. Looking at the stock market, he said, “I feel like an oversexed guy in a harem.”)

The story of his investment success has been told often, here and elsewhere: his devotion to the rigid analysis of balance sheets and P&L statements advocated by his teacher Benjamin Graham; his partnership with Charles Munger, which influenced Buffett to modify some of his earlier concepts. Suffice it to say that Buffett has done in stocks and companies what shrewd collectors have done in art: recognized quality before the crowd does. Today Berkshire Hathaway has a market capitalization of \$73.5 billion, and Buffett is a national hero.

He is number two, behind Bill Gates, on the FORBES list of the 400 richest people in the U.S., with \$29 billion in Berkshire Hathaway shares. Munger, the acerbic lawyer and Buffett’s partner for 40 years, ranks 153, with \$1.2 billion. Buffett’s wife, Susan, whom he married in 1952, has \$2.3 billion, ranking her 73 on The Forbes 400. Though FORBES could not find them all, we are confident that there are scores of Berkshire centimillionaires.

The Bunch has a few things in common: By and large they haven’t used their new wealth to finance jet-set living. Dr. Angle is rather typical. She doesn’t fly first class; she wouldn’t dream of buying a Mercedes. “There isn’t that much to spend money on in Omaha ... and if you do, you’re highly suspect,” she laughs. It has been a fun ride for her. She checks her computer every day for an update on her net worth. In a self-selective way, then, many of the Bunch are somewhat like the Master, pleased with their wealth but not overwhelmed by it.

They do have one other thing in common: a faith in Buffett that transcends bull and bear markets, a dislike for paying unnecessary capital gains taxes that has influenced them to hang on even when the stock sometimes seemed overpriced—and an understanding that it’s smarter to look for a steady 15% or so compounding of your money than to search for hot stocks that could double or treble in a short time. There has never been a shortage of naysayers warning that Berkshire was overpriced. (Only last month the *New York Times* so proclaimed.)

At times its price has been volatile; by September the shares were down 27% from their July peak of \$84,000. For many of the Berkshire Bunch that meant paper losses running into the hundreds of millions.

The Berkshire Bunch grew slowly. The first members were friends and family from Omaha. Daniel Monen, 71, the attorney who drew up all of Buffett’s partnership papers, borrowed \$5,000 from his mother-in-law to invest in 1957. “Most lawyers die at their desks,” he chuckles to FORBES. “I could

quit when I was 55 because of Warren Buffett.”

A wealthy Omaha neighbor, Dorothy Davis, invited Buffett over to her apartment one evening in 1957.

“I’ve heard you manage money,” she said,” Buffett recalls. “She questioned me very closely for two hours about my philosophy of investing. But her husband, Dr. Davis, didn’t say a word. He appeared not even to be listening.

“Suddenly Dr. Davis announced, ‘We’re giving you \$100,000.’”

“How come?” I asked. He said, ‘Because you remind me of Charlie Munger.’”

Who? Buffett didn’t know Munger yet.

The meeting boosted Buffett’s money under management from \$500,000 to \$600,000. More important, it planted a seed that was to pay off in two years, when Davis finally introduced Buffett to Munger, a fellow Omaha native who had moved to Los Angeles.

Many of the second wave of the Buffett Bunch were Columbia Business School classmates of Buffett’s. There is Fred Stanback, a wealthy native of North Carolina and later best man at Buffett’s wedding. In 1962 he entrusted \$125,000 to Buffett.

Others joined the Bunch because they recognized in Buffett a fellow admirer of investment guru Ben Graham. These included William Ruane of the Sequoia Fund, David Gottesman of First Manhattan and the late Phil Carrett of the Pioneer Fund.

“Anyone who came in contact with Warren bought the stock. It was one of the clearest decisions a person could make,” says Gottesman. His firm holds over 6,000 shares, worth some \$368 million, for its clients. Ruane’s Sequoia Fund holds 20,975 shares, 34% of its total portfolio.

Later in the 1960s the big money began to catch on. Laurence Tisch (Forbes 400 rank 80) and Franklin Otis Booth Jr., cousin of the Los Angeles Chandler family, became investors. Some members almost stumbled in, owning stock in the old Berkshire Hathaway and hanging on when Buffett turned it into an investment company.

Notably the Chace family of Rhode Island. In 1962 Buffett started buying shares in Berkshire Hathaway, a beleaguered New Bedford, Mass. manufacturer. Its chairman was a man named Malcolm Chace, scion of an old New England family. To Buffett Berkshire seemed a classic Ben Graham situation, selling as it was at \$7.50 a share versus net working capital of \$10 a share.

Buffett took control in 1965 and gradually liquidated the working assets. Malcolm Chace was still a shareholder, though Buffett’s open-market purchases had given him undisputed control.

The stubborn Chace didn’t sell to Buffett. His holding now controlled by his heir Malcolm Chace III, is worth about \$850 million.

Ernest Williams, former head of Mason & Lee, a Virginia

brokerage, read an article by Buffett and, in 1978, began buying as many shares as he could get; today he and his family own more than 4,000 shares, worth some \$250 million.

When Robert Sullivan, of Springfield, Mass., was a 19-year-old college student in the early 1970s he first read Ben Graham's *Intelligent Investor* and Graham and David Dodd's textbook on investment management. He began buying Berkshire, at \$380 a share, as well as Wesco Financial Corp., a company controlled by Buffett and Munger.

Legendary MIT economics professor Paul Samuelson is a big shareholder. To his students Samuelson preached the efficient market theory of investing, which says it's just about impossible to beat the market. In his own investing, however, Samuelson picked a market-beater.

With the Master's present fame, and with a Class B stock now available worth just 3% of an A share, Berkshire's owners, an elite group of the faithful no longer, now number 190,000.

Along the way Berkshire has become a medium for families to cash out their ownership in private companies. Besides its stockholdings and insurance companies, Berkshire shelters a raft of small and medium-size companies that publish newspapers, make shoes and sell candy, jewelry, furniture and encyclopedias. (But don't bother to apply unless your company meets the very rigorous Buffett-Munger standards.)

Buffett prefers to buy such businesses for cash, but he can be armtwisted into parting with Berkshire stock if he wants your company badly enough. William Child, the chief executive of R. C. Willey Home Furnishings, a Salt Lake City-based furnishing store, is one of those fortunate ones.

Just before selling out to Buffett, Child got some sage advice from grandsons of Rose Blumkin, the then-99-year-old former owner of Nebraska Furniture Mart in Omaha, who sold out to Berkshire in 1995.

"My friends the Blumkins told me they made a very bad mistake selling their company to Buffett for cash. They told me, no matter what, you don't take cash, and no matter what you do, don't sell your Berkshire stock. And I didn't," says Child.

Child got 8,000 shares in June 1995. The price then was \$22,000 a share. Today it is \$61,400, giving Child a net worth of almost \$500 million.

Albert Ueltschi, a native of Kentucky, received 16,256 shares of Berkshire when he sold his company, FlightSafety International, to Berkshire in 1996. Today those shares are worth about \$1 billion.

Harold Alfond and his family exchanged their ownership of Dexter Shoe Co. for 25,203 shares of Berkshire in 1995.

Alfond never sold a share; the position today is worth \$1.5 billion.

As you might expect, there are a lot of people out there kicking themselves for not keeping the faith. In the 1970s bear market the carnage was terrible. Berkshire fell from \$80 in December 1972 to \$40 in December 1974. Gloom and doom were everywhere. Year after year people withdrew more money from mutual funds, and a FORBES competitor emblazoned "The Death of Equities" on its cover. All this suited Buffett fine. As he has put it many times, "You pay a steep price in the stock market for a cheery consensus." Others were buying bonds; he was buying stocks. But some of his followers bought the consensus and sold out. Black day, for them.

Along the way others have bailed out for different reasons. Marshall Weinberg, a Columbia classmate who became a stockbroker at Gruntal & Co., sold some stock to make contributions to various causes. William (Buddy) Fox left Wall Street and cashed in his Berkshire stock to move to Australia. Buffett's close associate Tom Knapp was prohibited from building a major position in Berkshire shares because his firm Tweedy Browne was Buffett's broker during the early stage of Buffett's accumulation.

Laurence Tisch sold his position to avoid, he claims, being criticized for being a Buffett investor when both men might be interested in the same stocks.

At least one member of the Berkshire Bunch was forced out by circumstances. He is J.P. (Richie) Guerin, vice chairman of PS Group Holdings, an aircraft-leasing and oil-and-gas production outfit. His PS Group had to sell 5,700 shares of Berkshire at a relatively low price to pay off bank debts.

When Berkshire's takeover of General Reinsurance in a \$22 billion stock swap is accomplished in the fourth quarter, Berkshire will inherit an entirely new group of investors: Seventy percent of Gen Re is held by mutual funds, insurance companies and pension funds.

Will they stay with Berkshire? Buffett fully expects a fair number to defect. He told FORBES: "The first investors just believed in me. The ones who had faith stayed on; you couldn't get my Aunt Katie to sell if you came at her with a crowbar. But the people who came in later because they thought the stock was cheap and they were attracted to my record didn't always stay. It's a process of natural selection."

Buffett can never resist a chance to throw out a quip (though we must say, it wasn't one of his best): "You might say it's the survival of the fittest—financially fittest." **F**

RISK COMES FROM NOT KNOWING WHAT YOU'RE DOING.

A Son's Advice To His Father

HOWARD BUFFETT DOES NOT EXPECT TO INHERIT HIS DAD'S PLACE ON THE FORBES 400, BUT HE HARDLY SEEMS BITTER.

BY DYAN MACHAN



Howard Buffett, 43, a son of legendary investor Warren Buffett, 68, once ran for a public office in Omaha. His father had some advice: change the capital "B" in Buffett on the campaign posters to a lower case "b." "I'm the Buffett with the capital," Howard recalls his father saying.

But of course this is no laughing matter, a relationship between a very rich dad (or mom) and the kids. Just ask Howard Buffett.

Though he's based in Decatur, Ill., we meet Howard for lunch at the Hilton hotel near Kennedy airport in New York

just hours before his flight to South Africa. He's headed off for a photo safari and vacation with his wife, Devon, and son, Howie.

We order Cokes and sandwiches. After a bit of warmup talk, I get to the point—Howard, your dad has let the world know that his three children, Howard, Susan and Peter, will get only a modest sum from his eventual estate.

"I've never spoken about this, so I have to be careful," says Howard Buffett, taking a long, deep breath. Devon, who is clearly supportive of her husband, has joined us for the first part of the interview. She gives him an uneasy look that says,

Careful, Howard.

"All three of us would say there have been times when it's been very frustrating," says Howard reflectively.

He tells a story to illustrate his point:

"When I graduated from high school in 1973, all I wanted in the world was a new Corvette," the young Buffett begins.

Dad didn't just say no. Neither did he reach for his checkbook. He offered a deal.

Warren would pay \$5,000 toward the car, but it counted for three years of birthday presents, three years of Christmas presents, his entire graduation gift, and Howard would have to come up with the \$2,500 balance on his own.

Howard got the car.

Then somebody backed into it. Buffett overheard a bystander exclaim: "No big deal! That's the Buffett kid, there's lots more where that came from."

Fat chance. Howard paid for the repairs himself.

Howard is a thin-skinned, less driven version of his father. His vulnerability shows through just about every sentence.

Still, does having a father worth \$29 billion or so make a difference? Howard hesitated.

"I don't know for sure," he says at last, "but I think I would have made the same choices that I've made." Howard stands up and stretches. He had told me earlier his back is hurting, and he's had to take some painkillers.

So what were those choices, Howard?

He explains that like a lot of children, rich or poor, it took time for him to find his own identity. He bounced around several different colleges before finally dropping out. He attended Augustana College in 1974, Chapman College in 1975 and the University of California at Irvine in 1976.

His brother and sister dropped out, too. Clearly, if the withholding of inheritance was supposed to fire academic drive, it backfired in this case.

After a few jobs—operating a bulldozer; working for See's Candies, one of his dad's companies; and farming—Howard thought he'd take a stab at politics. It was 1988, and he ran for commissioner of the Douglas County board that oversees the Omaha district.

Sitting up straighter in his chair, he raises his voice a few decibels: "I've always been interested in politics. My grandfather, a Republican congressman from 1942-52 [and Howard's namesake], is the person my dad most respected in life.

"I asked my dad one question that, if he had answered differently, I might not have run for office. I asked him if he thought voters would think less of you if you ran for political office and lost. Dad instantly responded: 'Not at all. People will respect you if you are willing to participate and put yourself on the line.'"

Not that Howard agrees with his father on everything. Warren, repudiating his own father's politics, is a Democrat; Howard, like Grandpa Howard, is an active Republican.

Howard made the run, and his opponent, a woman, Lynn Baber, ran on the slogan, "I'm nobody's son."

Warren had made another deal. He would match 10% of whatever funds his son could raise.

"Howard, did you say 10% or 100%?" I ask. He looks at his hands, he looks at the ceiling, then back at me: "10%," he repeats with a sigh. "It was a good solution." Good for Howard, because it forced him to work like hell to raise money. Dad wrote that check, but reluctantly, Howard says.

During the campaign there was a community meeting in one of Omaha's poorer districts. Howard was nervous. "They're all going to think I'm just some rich kid from West Omaha," he confided to his dad, again asking for advice. "Just go down there, shake hands, be friendly," Warren responded. "They're all going to think you're going to be a jerk, and so as long as you're not a jerk, you win."

Sure enough, during the first moments of that meeting, a woman stood up and pointed accusingly: "'You're that rich guy's son!'" recalls Buffett. "I just said, 'Yes, but I don't have his money,' and laughed."

This anecdote obviously held an important lesson for Howard. It reminded him that in interpersonal relationships who you are on paper is just a starting place. When given a chance to meet you in person, people generally make up their own minds.

From all accounts, Howard was a superb commissioner—willing to take on tough issues and sensitive on human matters. He met every Tuesday for lunch with Warren, and they'd hash over all the goings-on. Howard was so popular there was even talk of a run for governor.

Not ready for so public a role, Howard began to focus on a growing interest in agriculture, which led to his involvement at Archer-Daniels-Midland.

Chief Executive Dwayne Andreas asked Howard to join his board in 1991. In 1992 he asked Howard to become his executive assistant and to act as company spokesperson.

"My background in politics and agriculture gave me the experience I needed," says Buffett. "I was getting to the big leagues on my own."

Then came the allegation of price fixing by certain senior ADM executives. The news hit at the end of June 1995.

At this point in the conversation Buffett put his sandwich down: "I remember as a kid the strike against the *Buffalo Evening News*—a Berkshire Hathaway property—in 1980. I listened to my father talking on the phone for hours. Over principle my dad was willing to shut down the newspaper and take the loss. He figured out the math. He could go six days without publishing and still start up again. He told the union they could strike for six days, and if they didn't come back, he would shut it down and no one would have a job. The strikers came back.

"I learned there are times you have to sacrifice for something bigger. You stand your ground and don't back down."

At ADM Howard chose to stand his ground. He quit, just weeks after the scandal erupted, a move many interpreted as bailing out. Howard saw it as a matter of principle.

"I knew I'd be criticized. I knew I would lose friendships. I gave up a significant amount of stock options and put my life in turmoil. But I was spokesperson and in charge of investor relations. How could I be a mouthpiece when I didn't and couldn't know what was accurate or inaccurate?"

There are times in an interview to just listen. This was one. I listened, entranced.

After resigning from ADM, Buffett looked around and made a modest investment to become chairman of Assumption, Ill.-based GSI Group, a private company making agricultural equipment. He also became more involved in one of his other passions—wildlife photography. His photographic company, Bioimages, sells Buffett's cards to museums and bookstores around the country—thus the photo shoot in South Africa.

Even though Warren had nothing to do with GSI, his long shadow still cast itself over Howard's work. "I understand my dad's in a unique position and has to be careful," Howard begins. "GSI, my company, recently had a road show to sell our high-yield bonds. It would have been appropriate for me to go. But I called my father for advice, and we agreed I should not do it so that there would be no confusion about which Buffett was involved."

Buffett stops eating and looks downcast. Not doing the GSI presentations to the investment community in 1997 was part of what he earlier referred to as the frustrating part of being Warren's son. "If we do an initial public offering, I can't keep my head buried in the sand. I have that obligation to my partners and to myself."

He brightens noticeably when talk turns to being invited by his dad to join the Berkshire Hathaway board in 1992. That says a lot, I tell Howard.

"I never looked at it that way," Howard says. "I never knew whether I would be asked or not. I didn't ask why."

Howard has struggled to find his place in the world, but he's well on his way. He enjoys his 640-acre farm: "I wouldn't take a job where I couldn't farm," he says. He enjoys his work at GSI and still harbors a lust for politics. His mother, Susan Buffett, had no small influence there. Howard is extremely close to his mother, who also sits on the Berkshire Hathaway board. "She is simply the most generous, kindest and most caring person I've ever known," Howard gushes. "It's her interest in looking out for other people that's instilled my true interest in politics."

Then he stops himself. I could see he was concerned that

he'd already said too much. His mother guards her privacy. Howard respects that but wants us to know that she has been equally influential as his father in shaping his life. "Equal if not more," he says.

On our third Coke, I ask: "How is her philosophy and yours different from your father's?"

"Well, he's a little more of a hard-liner. He'll say you've got to go out and earn it. If you give stuff to people they won't learn how to earn." Howard pauses and says, "I don't disagree with that, but there are exceptions to every thing."

Every healthy family crafts solutions to smooth over the little rough spots of familial dissension. The Buffett family is no different. (When the Buffett family dines at a restaurant, Howard's sister always takes the bill and adds the tip—Dad can't be trusted to tip generously enough.)

Taking the last bite of his sandwich, Buffett talks about his own son: "He's got to have pride in what he does and excel. I won't give him his first car—I adopt my dad's attitude in general"

You'll do every thing as your dad did?

Not quite. "I will always try to include him. Howie is interested in politics, so when I had lunch with Paul Simon—the former Illinois senator—at the Capitol, Howie went with me. Howie was 6 years old." Warren just didn't do that kind of thing.

"I always tell my son the most important thing he can do is find a few really good mentors, which I have always had."

As the waitress clears the plates and only minutes remain before Buffett embarks for Africa, I ask: Aren't you at all bitter about being cut off from all those billions of dollars?

"The truth is, if Dad loaded us with money, he could not help but control us. He let us go our own way. 'Find something you love to do,' he's always said, 'and do it.'"

As he gets up from the table he looks at me and says, "My family is close. We get together often." Then, smiling, he adds, "In our family no one is jockeying for position."

Time for the plane. Howard has already arranged to have the check paid, so there is no argument, and I walk the family to the bus that will carry them to the airport. He has some parting words:

"As I look back, Dad's done enough at certain times to be helpful. Our lives are better because of his generosity. He's a great listener, and I have had great advice."

Then with a broad smile he adds: "Now we'd love to have him loosen up a little!" **F**

YOU ONLY HAVE TO DO A VERY FEW THINGS RIGHT IN YOUR LIFE SO LONG AS YOU DON'T DO TOO MANY THINGS WRONG.



A Word From A Dollar Bear

WARREN BUFFETT'S VOTE OF NO CONFIDENCE IN U.S. FISCAL POLICIES IS UP TO \$20 BILLION.

BY ROBERT LENZNER AND DANIEL KRUGER

The dollar has fallen savagely against the euro for the past three years, and the trade deficit is running \$55 billion a month. Is the currency rout over? Can the trade deficit be fixed with a rise in interest rates or an upward revaluation of the Chinese currency? Warren Buffett, the world's most visible dollar bear, says the answer to both these questions is no. His bet against the dollar, reported at \$12 billion in his last annual report (for Dec. 31, 2003), has gotten all the bigger. Now his Berkshire Hathaway has a \$20 billion bet in favor of the euro, the pound and six other foreign currencies.

Buffett has for a long time been lecturing fellow Americans about their bad habit of borrowing from abroad to live well today. He made a big stink about his currency trades in his March 2004 letter to shareholders. FORBES phoned him

recently for an update, hoping for the news that the Scold of Omaha had softened his views on the decline of the dollar. What we got was more doom and gloom, more than we have ever heard from the man. In other words, he is not about to cover his short position on the dollar.

Buffett said that he began buying foreign currency forward contracts when the euro was worth 86 U.S. cents, and kept buying until the price reached \$1.20. It's now worth \$1.33. Buffett said he is not adding new positions now but has been rolling over contracts as they mature. Berkshire lost \$205 million on currency speculations in the first half of 2004, but more than made that back with a \$412 million gain in the third quarter. It's likely that the December quarter report will show another huge gain.

Since January 2002 the dollar has fallen 33% against the

euro. Buffett blames that on bad policy, coming from both the White House and Congress. It does appear that forex speculators are no big fans of George Bush or his Treasury secretary, John Snow. Since Nov. 2 the dollar has fallen 4.4% against the euro.

Says Buffett: “The rest of the world owns \$10 trillion of us, or \$3 trillion net.” That is, U.S. claims on foreign assets run to only \$7 trillion. “If lots of people try to leave the market, we’ll have chaos because they won’t get through the door.” In a nutshell, the trade deficit is forcing foreign central banks to ingest U.S. currency at a rate approaching \$2 billion a day. Buffett continues: “If we have the same policies, the dollar will go down.”

The \$20 billion bet has to be put in context. Berkshire has a huge portfolio of investments that includes \$40 billion of Treasury securities. Budget and trade deficits are likely to make dollars worth less and bonds worth less. So the currency play is a partial hedge of a large position that can be read as bullish on the U.S.

Still, that Buffett is making a currency bet at all is striking given that this investor has, in his 74 years, rarely made macroeconomic bets. He built Berkshire to a \$130 billion market value by acquiring parts or all of lots of businesses, primarily in the insurance sector and primarily in the U.S. Now some of those assets are antidollar assets. Example: In 2002 he bought bonds of Level 3, a telecom company, that were denominated in euros. In 2000 Berkshire picked up MidAmerican Energy, a gas pipeline company. By doing so, Berkshire indirectly acquired the assets of Northern Electric, a utility in England, at a time when the pound was worth \$1.58. Now it’s worth \$1.94, so Berkshire has a paper gain irrespective of any appreciation in the electric company’s pound-denominated earning power.

A continuing fall in the dollar “could cause major disruptions in financial markets. There could be unpredictable side effects. It could be precipitated by some exogenous event like a Long-Term Capital Management,” Buffett says, referring to the 1998 collapse of a steeply leveraged hedge fund.

How about a soft landing for our deficit-addicted

economy? Don’t count on it. We’re running \$100 billion a year in the hole against China, but Buffett doesn’t expect that an upward revaluation of the renminbi (stoutly resisted, in any event, by the Chinese government) would greatly reduce this number.

How about a rise in short-term interest rates? They used to say on Wall Street, “Six percent interest will draw money from the moon.” Buffett is skeptical, though, that the recent tightening by Fed Chairman Alan Greenspan will do much more than “put off the day of reckoning”

Nor does Buffett support the notion that intervention in the currency markets by one or another central bank can overcome the momentum of a currency that’s losing value. “Sooner or later markets win over the intervenors. The intervenors always run out of gas,” says Buffett.

What is absolutely necessary to bolster the dollar is “a public policy that brings imports and exports together.” Buffett has proposed a grand scheme to force imports and exports into perfect balance by demanding that each dollar of imports be accompanied by a certificate bought from an exporter who moved a dollar the other way. He concedes, using the self-deprecating humor for which he is known, that this scheme has met with deafening silence from policymakers.

Moving beyond cloudland to economic history, Buffett reflects wistfully on the writings of David Ricardo, the 19th-century trade theorist: “In those days the trade imbalances got settled in gold—and when they ran out of gold, people stopped doing business with you.” A gold standard? More wishful thinking. But Buffett is no goldbug. It’s more that he’s an antidollar bug. In dollar terms, gold, copper and oil have all climbed in the past several years; in euros, not so sharply.

So, Warren, what are you buying now? And what’s your prediction for the dollar next year? His answers, respectively: No comment, and I’m not making one.

But here’s a long-term perspective. He says he may hold foreign currencies “for years and years.” And he says that the electorate of the U.S. may be strongly tempted to get out of hock by inflating away the country’s dollar debts. **F**

THERE SEEMS TO BE SOME PERVERSE HUMAN CHARACTERISTIC THAT LIKES TO MAKE EASY THINGS DIFFICULT.