CENTRE FOR FINANCIAL MANAGEMENT
CFM QUARTERLY IN FINANCE
JULY 2020
EDITOR: DR. PRASANNA CHANDRA
CONTENTS

ARTICLES /CASES

BERKSHIRE HATHAWAY: VALUE CREATION PAR EXCELLENCE[1]

Prasanna Chandra

If there were a Nobel Prize for rational investing or for creating value for shareholders, Warren Buffett the legendary Chairman of Berkshire Hathaway Inc. (Berkshire, hereafter) would perhaps be the strongest contender for the same. No wonder then that Barron's Magazine named Berkshire as the most respected company in the world in 2007 based on a survey of American money managers. One of the most outstanding managers and investors of our time, Buffett transformed a lackluster textile company into a powerful investment vehicle. When he acquired control of Berkshire in 1965, he was attracted by the surplus cash in the company which he used to buy a 100 percent stake in two insurance companies, viz., The National Indemnity Company and The National Fire and Marine Insurance Company. Then he started investing a major portion of the 'insurance float' of his insurance companies in equities and acquiring

other companies departing from the conventional practice of using 'insurance float' largely for fixed income securities.

Berkshire has rewarded its shareholders phenomenally over a period of time. Its share price appreciated from $19 in 1969 to an unbelievable $338,080 by the end of 2019. This can be attributed mainly to Warren Buffett's investment genius and superb managerial skills. As Buffett puts it, "I am a better businessman because I am an investor. And I am a better investor because I am a businessman."

How did Warren Buffett manage to create phenomenal value? What principles guided his business and investment actions? Answers to these questions can be found by perusing the annual reports of Berkshire which provide an extremely authentic, perceptive, and professional discussion of Berkshire's business and its strategies. Indeed these reports are a treasure of wisdom on business and finance. This case discusses Berkshire's business principles, after a brief write-up on Berkshire's business activities and financials.

[1.] Writing this case was a fairly easy task because Warren Buffett, an ace communicator, has spelt out very clearly his business philosophy and business principles in his annual letters to his shareholders. This case quotes heavily from the annual letters written by Warren Buffett to the shareholders of Berkshire.

Business Activities

Berkshire is a conglomerate holding company headquartered in Omaha, Nebraska, that oversees and manages scores of subsidiary companies engaged in diverse businesses which may be broadly classified into the following groups.

- Insurance and Reinsurance Business (Examples: GIECO, Berkshire Hathaway Reinsurance Group, Berkshire Hathaway Primary Group).
- Railroad Business – Burlington Northern Santa Fe
- Utilities and Energy Businesses – Berkshire Hathaway Energy
- Manufacturing Businesses (Examples: Precision Cast Parts Corporation, Lubrizol Corporation, IMC International Metalworking Companies, Marmon Holdings, Clayton Homes)
- Service and Retailing Businesses (Examples: Net Jets Inc. XTRA Corporation, Nebraska Furniture Mart, See's Candy)

To help investors roughly estimate Berkshire's intrinsic business value, Buffett classifies the many and diverse businesses of Berkshire Hathaway into five "groves" as follows:

1. The most valuable grove in Berkshire's forest remains the many dozens of non-insurance businesses that Berkshire controls (usually with 100% ownership and never with less than 80%).
2. The runner-up grove by value is its collection of equities, typically involving a 5%–10% ownership position in a very large company. At 2018 year end, this grove was worth nearly $ 173 billion.

3. A third grove of Berkshire's business ownerships is a quartet of companies in which Berkshire shares control with other parties.
4. The fourth grove consists of U.S. Treasury bills and cash equivalents and miscellaneous fixed-income instruments. At 2018 year end, this grove was worth $132 billion.
5. The fifth grove consists of Berkshire's huge and diverse insurance business.

Buffett makes a point of key and lasting importance: "Berkshire's value is maximized by our having assembled the five groves into a single entity. This arrangement allows us to seamlessly and objectively allocate major amounts of capital, eliminate enterprise risk, avoid insularity, fund assets at exceptionally low cost, occasionally take advantage of tax inefficiencies, and minimize overhead." He adds, "At Berkshire, the whole is greater – considerably greater-than the sum of the parts."

Financials

The summarized consolidated balance sheets and statement of earnings of Berkshire are shown in Exhibits 1 and 2.

Exhibit 1 ***Consolidated Balance Sheets***

	(Dollars in millions) December 31	
	2018	*2017*
Assets		
Insurance and Others	532,307	530,167
Railroad, Utilities and Energy	175,487	171,928
	$ 707,794	$ 702,095
Liabilities and Shareholder's Equity		
Liabilities		
Insurance and Others	$ 222,488	212,511
Railroad, Utilities and Energy	81,431	81,023
Income taxes, principally deferred	51,375	56,607
Total liabilities	355,294	350,141
Shareholder's Equity		
Common stock	8	8
Capital in excess of par value	35,707	35,694
Accumulated other comprehensive income	(5,015)	58,571
Retained earnings	321,112	255,786
Treasury stock, at cost	(3,109)	(1,763)
Berkshire Hathaway shareholder's equity	348,703	348,296
Non-controlling interests	3,797	3,658
Total shareholder's equity	352,500	351,954
	$ 707,794	$ 702,095

Exhibit 2 ***Consolidated Statements of Earnings***

	Year Ended December 31		
	2018	*2017*	*2016*
Revenues			
Insurance and Others	204,164	199,928	177,667
Railroad, Utilities and Energy	43,673	40,005	37,447
Total revenues	247,837	239,933	215,114
Investment and derivative contract gains (losses)	(22,445)	2,128	8,304
Costs and expenses			
Insurance and Others	184,815	189,949	162,024
Railroad, Utilities and Energy	34,399	31,288	28,836
Total costs and expenses	219,214	221,237	190,860
Earnings before income taxes and equity method earnings (losses)	6,618	20,824	32,558
Equity method earnings (losses)	(2,167)	3,014	1,109
Earnings before income taxes	4,001	23,838	33,667
Income tax expense (benefit)	(321)	(21,515)	9,240
Net Earnings	4,322	45,353	24,427
Earnings attributable to non-controlling interests	301	413	353
Net earnings attributable to Berkshire Hathaway shareholders	$4,021	$ 44,940	$24,074
Net earnings per average equivalent Class A share	$2,446	$ 27,326	$14,645
Net earnings per average equivalent Class B share	$1.63	$ 18.22	$9.76
Average equivalent Class A shares outstanding	1,643,795	1,644,615	1,643,826
Average equivalent Class B shares outstanding	2,465,692,368	2,466,923,163	2,465,739,654

*Class B shares are economically equivalent to one-fifteen-hundredth of a Class A share. Accordingly, net earnings per average equivalent Class B share outstanding is equal to one-fifteen-hundredth of the equivalent Class A amount.

Investments

Berkshire has a very valuable portfolio of equities, bonds, and other instruments. Exhibit 1.3 lists fifteen common stock investments that at year end had the largest market value. Further, it had equity method investments of $17.3 billion. In addition, as on that date, Berkshire had $27.74 billion of cash and cash equivalents, $81.5 billion of short-term investments in U.S. Treasury Bills, and $19.9 billion of investments in fixed maturity securities.

Exhibit 3 ***List of Fifteen Common Stock Investment of Berkshire that at Year end had the Largest Market Value***

Shares*	Company	Percentage of Company Owned	Cost**	Market
			(in millions)	
151,610,700	American Express Company	17.9	$ 1,287	$ 14,452
255,300,329	Apple Inc.	5.4	36,044	40,271
918,919,000	Bank of America Corp.	9.5	11,650	22,642
84,488,751	The Bank of New York Mellon Corp.	8.8	3,860	3,977
6,789,054	Charter Communications, Inc.	3.0	1,210	1,935
400,000,000	The Coca-Cola Company	9.4	1,299	18,940
65,535,000	Delta Air Lines, Inc.	9.6	2,860	3,270
18,784,698	The Goldman Sachs Group, Inc.	4.9	2,380	3,138
50,661,394	JP Morgan Chase & Co.	1.5	5,605	4,946
24,669,778	Moody's Corporation	12.9	248	3,455
47,890,899	Southwest Airlines Co.	8.7	2,005	2,226
21,938,642	United Continental Holdings Inc.	8.1	1,195	1,837
146,346,999	U.S. Bancorp	9.1	5,548	6,688
43,387,980	USG Corporation	31.0	836	1,851
449,349,102	Wells Fargo & Company	9.8	10,639	20,706
	Others		16,201	22,423
	Total Common Stocks Carried at Market		$102,867	$172,757

*Excludes shares held by pension funds of Berkshire subsidiaries.
** This is our actual purchase price and also our tax basis.

Key Business Principles

The key business principles followed by Berkshire, as culled out from the annual reports and other writings of Warren Buffett, may be discussed in terms of the following dimensions of the value octagon:

- Strategy and business model
- Capital allocation
- Strategic financing decisions
- Organizational architecture
- Cost management
- Corporate risk management
- Mergers, acquisitions, and restructuring
- Corporate governance

Strategy and Business Model

Stay Within Your Circle of Competence Warren Buffett believes that every person should invest in businesses that he understands. As he says, "Draw a circle around the businesses you understand and then eliminate those that fail to qualify on the basis of value, good management, and limited exposure to hard times." He further adds, "The most important thing in terms of your circle of competence is not how large the area of it is, but how well you've defined that perimeter. If you know where the edges are, you're way better off than somebody that's got one that's five times as large but they get very fuzzy about the edges."

Build Moats If Berkshire exploits floats on the liabilities side, it seeks to build moats on the assets side that make life difficult for its competitors. As Buffett put it, "What we're trying to find is a business that for one reason or another—because it's the least-cost producer in some area, because it has a natural franchise due to its service capabilities, because of its position in the consumer's mind, because of a technological advantage or any kind of reason at all—has this moat around it. And you throw crocodiles and sharks and piranhas in it to make it harder and harder for people to swim across and attack the castle." According to Buffett, "A truly great business must have an enduring moat around its economic castle that protects its excellent returns on invested capital."

A strong moat is often reflected in a large negative working capital, near-zero debt, a liquid balance sheet, and a high return on capital employed. It appears that floats and moats go together.[2]

Capital Allocation

Focus on Intrinsic Value Berkshire's decisions are guided by the intrinsic value principle. As Buffett writes:"Intrinsic value is an all-important concept that offers the only logical approach to evaluating the relative attractiveness of investments and businesses. Intrinsic value can be defined simply: It is the discounted value of the cash that can be taken out of a business during its remaining life."

Buffett recognizes the difficulty in calculating intrinsic value. As he puts it, "The calculation of intrinsic value, though, is not so simple. As our definition suggests, intrinsic value is an estimate rather than a precise figure, and it is additionally an estimate that must be changed if interest rates move or forecasts of future cash flows are revised. Two people looking at the same set of facts, moreover—and this would apply even to Charlie and me—will almost inevitably come up with at least slightly different intrinsic value figures. That is one reason we never give you our estimates of intrinsic value. What our annual reports do supply, though, are the facts that we ourselves use to calculate this value."

---

[2]. Sanjay Bakshi, "Presentation on Floats & Moats," Fundoo Professor, December 6, 2012.

For purposes of communicating with investors, Buffett uses per-share book value. As he says: "Meanwhile, we regularly report our per-share book value, an easily calculable number, though one of limited use. The limitations do not arise from our holdings of

marketable securities, which are carried on our books at their current prices. Rather the inadequacies of book value have to do with the companies we control, whose values as stated on our books may be far different from their intrinsic value."

Despite its limitations, Buffett considers per-share book value as a useful measure for tracking performance. As he puts it: "Inadequate though they are in telling the story, we give you Berkshire's book-value figures because they today serve as a rough, albeit significantly understated, tracking measure for Berkshire's intrinsic value. In other words, the percentage change in book value in any given year is likely to be reasonably close to that year's change in intrinsic value."

Owner Earnings

Warren Buffett measures and reports the performance of Berkshire Hathaway in terms of "owner e
defines it as follows:

Owner earnings = $a + b - c$

where

a = operating earnings

b = depreciation

c = average amount of capitalised expenditures for plant and equipment etc. that the business req
maintain its long-term competitive position and its unit volume.

Owner earnings appears to be a very sensible measure of periodic performance as it takes into
capital expenditure required to maintain the competitive strength.

Allocate Capital Flexibly Berkshire does not have a strategic plan which propels it in a particular direction with a certain compulsion. This gives it great freedom in moving capital smartly. As Buffett says: "Thus we feel no need to proceed in an ordained direction (a course leading almost invariably to silly purchase price) but can instead simply decide what makes sense for our owners. In doing that, we always mentally compare any move we are contemplating with dozens of other opportunities open to us, including the purchase of small pieces of the best businesses in the world via the stock market. Our practice of making this comparison—acquisitions against passive investments—is a discipline that managers focused simply on expansion seldom use." In a similar vein he notes elsewhere: "We are not in the steel business per se. We're not in the shoe business, per se. We're not in any business, per se. We're big in insurance but we're not committed to it. We don't have a mindset that says you have to go down this road. So we can take capital and move in into businesses that makes sense."

Buffett regards this flexibility as an important contributor to the company's success. As he says: "Our flexibility in respect of capital allocation has accounted for much of our progress to date. We have been able to take money we earn from, say, See's Candies or Business Wire (two of our best run businesses, but also offering limited reinvestment opportunities) and use it as part of the stake we needed to buy BNSF."

Use Conglomerate Structure for Rational Capital Allocation Berkshire uses the conglomerate structure effectively for rational capital allocation. As Buffett observes:

"In contrast, a conglomerate such as Berkshire is perfectly positioned to allocate capitally rationally at a minimal cost. Of course, form itself is no guarantee of success. We have made plenty of mistakes, and we will make more. Our structural advantages, however, are formidable. At Berkshire, we can without incurring taxes or much in the way of other costs–move huge sums from businesses that have limited opportunities for incremental investment to other sectors with greater promise. Moreover, we are free of historical biases created by lifelong association with a given industry and are not subject to pressures from colleagues having a vested interest in maintaining the status quo. That's important. If horses had controlled investment decisions, there would have been no auto industry."

Strategic Financing Decisions

Minimize the Use of Debt Berkshire uses debt sparingly. As Buffett says: "We rarely use much debt and when we do we attempt to structure it on a long-term fixed-rate basis. We will reject interesting opportunities rather than over-leverage our balance sheet."

Buffett admits that greater financial leverage would have increased the return on equity but defends his conservative posture. As he argues: "Our consistently conservative financial policies may appear to have been a mistake, but in my view were not. In retrospect, it is clear that significantly higher, though still conventional, leverage ratios at Berkshire would have produced considerably better returns on equity than the 23.8% we have actually averaged. Even in 1965, perhaps we could have judged there to be a 99% probability that higher leverage would lead to nothing but good…We wouldn't have liked 99:1 odds and never will. A small chance of distress or disgrace cannot, in our view, be offset by a large chance of extra return."

Finance Proactively not Reactively Opportunities for smart moves on investment and financing sides of the business often do not synchronize. Hence financing decisions should be decoupled from investment decisions. Buffett, arguably one of the most outstanding managers of our times, says: "Unlike many in the business world, we prefer to finance in anticipation of need rather than in reaction to it. A business obtains the best financial results possibly by managing both sides of its balance sheet well. This means obtaining the highest-possible returns on assets and the lowest-possible cost on liabilities. It would be convenient if opportunities for intelligent actions on both fronts coincided. However, reasons tell us that just the opposite is likely to be the case: Tight money conditions, which translate, into high cost for liabilities, will create the best opportunities for acquisitions, and cheap money will cause assets to be bid to the sky. Our conclusion: Action on the liability side sometimes to be taken independent of any action on the asset side.

"Alas! what is 'tight' and 'cheap' money is far from clear at any particular time. We have no ability to forecast interest rates and maintaining our usual open-minded spirit believe that no one else can. Therefore, we simply borrow when conditions seem non-oppressive and hope that we will later find intelligent expansion or acquisition opportunities, which as we have said are more likely to pop up when conditions in the

debt market are clearly oppressive. Our basic principle is that if you want to shoot rare, fast moving elephants, you should carry a loaded gun."

The central message of Buffett's insightful argument is: Finance proactively, rather than reactively.

Innovative Financing

In 2002, Berkshire Hathaway issued bonds with a 3 percent coupon rate, but they also had an entitling investors to purchase shares of Berkshire Hathaway at a fixed price in the future. How were not just given away – investors were required to pay an annual warrant fee equal to 3.75 per face value. From a tax point of view, Berkshire Hathaway can claim the 3 percent interest as a tax-d while 3.75 percent warrant fee is not taxable.

Retain Earnings Only When You Can Create More Value for Shareholders Berkshire Hathaway accords considerable thought to how its earnings should be disposed. According to Buffett, all earnings are not created equal. In many businesses, particularly those which have high capital intensity, thanks to inflation some or all of the reported earnings are "restricted". This means that these earnings cannot be distributed without impairing the competitive strength of the firm. As Buffett says: "Restricted earnings are seldom valueless to owners, but they often must be discounted heavily. In effect they are conscripted by the business, no matter what its economic potential."

The unrestricted earnings are like discretionary income. They may be retained or distributed. They should be retained only if the firm can create more value for shareholders. As Buffett says:"Unrestricted earnings should be retained only when there is a reasonable The unrestricted earnings are like discretionary income. They may be retained or distributed. They should be retained only if the firm can create more value for shareholders. As Buffett says:"Unrestricted earnings should be retained only when there is a reasonable

At Berkshire all earnings have been retained because the above condition has been satisfied. This is a monumental tribute to Buffett's ability to judiciously employ funds.

Repurchase Shares in a Rational and Fair Manner Berkshire repurchases its shares when they are selling at a discount to their intrinsic value, but in doing so it fully informs the selling shareholders and treats them fairly. Berkshire's approach to repurchase is explained by Buffett as follows: "Charlie and I favor repurchases when two conditions are met: first, a company has ample funds to take care of the operational and liquidity needs of its business; second, its stock is selling at a material discount to the company's intrinsic value, conservatively calculated.

"Charlie and I have mixed feeling when Berkshire shares sell well below intrinsic value. We like making money for continuing shareholders, and there is no surer way to do that than buying an asset—our own stock—that we know to be worth more….. Nevertheless we don't enjoy cashing out partners at a discount, even though our doing so may give the selling shareholders a slightly higher price than they would receive if

our bid was absent. When we are buying, therefore, we want those exiting partners to be fully informed about the value of the assets they are selling."

Exploit Floats Berkshire's insurance business generates float. As Buffett said, "Float arises because most policies require that premiums be paid and, more importantly, because it usually takes time for an insurer to hear about and resolve loss claims." According to Buffett, "This float is 'free' as long as insurance underwriting breaks even, meaning that the premiums we receive equal the losses and expenses we incur. Over our entire history, we've been profitable, and I expect we will average break-even results or better in the future. If we do that, our investments can be viewed as an unencumbered source of value for Berkshire's shareholders."

Berkshire's float has grown from a meager $17 million in 1967 to a staggering $122 billion by the end of 2018. And this float has been an important source of value. As Buffett puts it, "So how does this attractive float affect intrinsic value calculations? Our float is deducted in full as a liability in calculating Berkshire's book value, just as if we had to pay it out tomorrow and were unable to replenish it. But that's an incorrect way to view float, which should instead be viewed as a revolving fund. If float is both costless and long-enduring, the true value of this liability was far lower than the accounting liability."

Although Buffett regards derivatives as financial weapons of mass destruction, Berkshire avails of "derivatives float" by selling derivative contracts, just the way it benefits from "insurance float." By the end of 2008, Berkshire was a party to 251 derivative contracts, such as equity puts, credit default swaps, and others. As Buffett notes, "As of yearend, the payments made to us less losses we have paid—our derivatives 'float', so to speak—totaled $ 8.1 billion. This float is similar to insurance float: If we break-even on an underlying transaction, we will have enjoyed the use of free money for a long time. Our expectations are that we will do better than break-even and that the substantial investment income we earn on the funds will be a frosting on the cake."

Thus, thanks to the floats of Berkshire, it has an unencumbered source of value because the value of the liability is much less than book value and the free float levers ROA just the way debt levers ROCE. In effect, Berkshire has a super-efficient capital structure. Free float, indeed, is the best form of leverage.

Performance Management

Centralize Financial Decisions and Decentralize Operating Decisions At Berkshire Hathaway financial decisions are centralized at the top (the very top, indeed) and operating decisions are more or less completely delegated to a number of key executives managing individual companies or business units. This approach has produced spectacular results for three reasons, in the main: (i) Buffett and his partner Munger can concentrate their efforts on investment decisions in which they have exceptional skills. (ii) It eliminates large layers of overhead costs and dramatically speeds up decision making. (iii) It enables Berkshire Hathaway to attract and retain highly talented individual persons who have the satisfaction of virtually running their

own shows. As Buffett says: "We have placed much trust in them and their achievements have far exceeded that trust."

Describing Berkshire's approach Buffett wrote in the 1999 annual report: "There are no show-and-tell presentations in Omaha, no budgets to be approved by headquarters, no dicturns issued about capital expenditures. We simply ask our managers to run their companies as if these are the sole asset of their families and will remain so for the next century."

He further added in the 2009 annual report: "We tend to let our many subsidiaries operate on their own, without our supervising and monitoring them to any degree. We would rather suffer the visible costs of a few bad decisions than incur the many invisible costs that come from decisions made too slowly—or not at all—because of stifling bureaucracy. We will never allow Berkshire to become some monolith that is run by committees, budget presentations and multiple layers of management. Charlie and I will limit ourselves to allocating capital, controlling enterprise risk, choosing managers, and setting their compensation."

While Buffett does not interfere with the day-to-day management of operating companies, he is responsible for hiring and determining the compensation of the CEO. Further, the capital allocated to a business carries a price tag (hurdle rate).

Hire Well, Manage Little, and Be a Cheerleader Berkshire hires talented and committed people, gives them complete operational autonomy, and lets them run their shows with minimal interference. Buffett supports his managers, pats them on their back, and makes them feel good in his own inimitable style. This is evident from the following words expressed by him about his managers, "All of our operations, including those whose earnings fell last year, benefit from exceptionally talented and dedicated managers. Were we to have the choice of any other executives now working in their industries, there is not one of our managers we would replace. Many of our managers don't have to work for a living, but simply go out and perform everyday for the same reason that wealthy golfers stay on the tour. They love both doing what they do and doing it well. To describe them as working may be a misnomer-they simply prefer spending much of their time on a productive activity at which they excel to spending it on leisure activities. Our job is to provide an environment that will keep them feeling this way, and so far we seem to have succeeded. Thinking back over the 1965–95 period, I can't recall that a single key manager has left Berkshire Hathaway to join another employer."

Compensate CEOs of Operating Companies Fairly An important responsibility of Buffett is to determine the salaries and incentives for the CEOs of its operating businesses. Buffett describes how he does it: "Berkshire employs many different incentive arrangements, with their terms depending on such elements as the economic potential or capital intensity of a CEO's business. Whatever the compensation arrangement, though, I try to keep it both simple and fair. When we use incentives—and these can be large—they are always tied to the operating results for which a given CEO has authority." Obviously Berkshire has excelled in this task. As he says: "How much time does this aspect of my job take? Virtually none. How many CEOs have voluntarily left us for jobs in our 42-year history? Precisely none."

Berkshire's compensation arrangement is congruent with the shareholder value principle and is strikingly different from the common U.S. compensation practices. Buffett's annual salary of $100,000 puts him in the cellar of Fortune 500 CEO pay. Berkshire does not grant any employee stock options or restricted stock. While Buffett, in principle, is not against equity-based pay, he thinks that very few companies properly link pay and performance.

Buffett explains the company's compensation philosophy with reference to Geico, Berkshire's auto insurance business. The goals of the plan, Buffett says, "should be (1) tailored to the economics of the specific operating business; (2) simple in character so that the degree to which they are being realized can be easily measured; and (3) directly related to the daily activities of plan participants." He states that "we shun 'lottery ticket' arrangements… whose ultimate value … is totally out of the control of the person whose behaviour we would like to affect."

Buffett has been a trenchant critique of executive compensation in the U.S. As he puts it: "Too often, executive compensation in the U.S. is ridiculously out of line with performance. That won't change, moreover, because the deck is stacked against investors when it comes to the CEO's pay. The upshot is that a mediocre-or-worse CEO-aided by his handpicked VP of human relations and a consultant from the ever-accommodating firm of Ratchet, Ratchet and Bingo—all too often receive gobs of money from an ill-designed compensation arrangement."

Cost Management

Instill Cost Consciousness Frugality and cost consciousness are the hallmark of Berkshire. As Buffett says: "We cherish cost-consciousness at Berkshire. Our model is the widow who went on to the local newspaper. She was told there was a 25-cent-a-word charge, she requested 'Fred Brown died! She was then informed there was a 7-word minimum.'' 'Okay' the bereaved woman replied, 'Make it, 'Fred Brown died, golf club for sale!'

Berkshire's cost consciousness is reflected in the following numbers: The annual rent for its "World Headquarters" in 2010 was $270,212 and the yearend home-office investment in furniture, art, coke dispenser, lunch room, high-tech equipment—you name it—totaled $301,363. Justifying this, Buffett says: "As long as Charlie and I treat your money as if it were our own, Berkshire's managers are likely to be careful with it as well."

Risk Management

Maintain a Gibraltar-like Financial Position Right from the beginning, Buffett wanted Berkshire to be a financial fortress so that it protects the interests of employees, customers, policyholders, creditors, shareholders, and the community. To build its financial strength, Berkshire has allocated capital rationally and conserved its resources. Berkshire maintains a Gibraltar-like financial position, which features huge amounts of excess liquidity, near- term obligations that are modest, and dozens of sources of earnings and cash. As Buffett wrote in his 2010 annual letter to shareholders: "Furthermore, not a dime of cash has left Berkshire for dividends or

share purchases during the past 40 years. Instead, we have retained all our earnings to strengthen our business, a reinforcement now running to about $1 billion per month. Our net worth has increased from $48 million to $157 billion during those four decades and our intrinsic value has grown far more. No other American corporation has come to building up its financial strength in this unrelenting way."

The financial strength of Berkshire gives it great competitive advantage in writing mega reinsurance policies. As Buffett wrote in his 2009 annual letter to shareholders: "Over the years Ajit has built the National Indemnity's reinsurance operation into a one-of- a-kind giant in the insurance world. Staffed by only 30 people, Ajit's operation has set records for transaction size in several years of insurance. Ajit writes billion-dollar limits and then keeps every dime of the risk instead of laying it off with other insurers. Three years ago, he took over huge liabilities from Lloyds allowing it to clean up its relationship with 27,972 participants ("names") who had written problem-ridden policies that at one point threatened the survival of this 322-year-old institution. The premium of that single contract was $7.1 billion. During 2009, he negotiated a life reinsurance contract that would produce $50 billion of premium for us over the next 50 years or so. Ajit writes relatively few policies, and the mix changes significantly from year to year. Throughout the world, he is known as the man to call when something both large and unusual needs to be insured. If Charlie, I, and Ajit are ever in a sinking boat—and you can only save one of us—swim to Ajit."

Berkshire's financial strength gives it an edge in exploiting windows of opportunities in the financial markets. For example, in the years 2008 and 2009, Berkshire bought securities of Dow Chemicals, General Electric, Goldman Sachs, Swiss Re, and Wrigley for an aggregate cost of $21.1 billion. As Buffett wrote in the 2009 annual letter to shareholders: "We have put a lot of money to work during the chaos of the last two years. It's been an ideal period for investors. A climate of fear is their best friend."

Adhere to Proper Discipline in Writing Insurance The largest and the most profitable business in Berkshire's portfolio is the insurance business. It is mainly because of the discipline exercised by Berkshire.

As Warren Buffett said, "At bottom, a sound insurance operation needs to adhere to four disciplines. It must (1) understand all exposures that might cause a policy to incur losses; (2) conservatively evaluate the likelihood of any exposure actually causing a loss and the probable cost if it does; (3) set a premium that will deliver a profit, on average, after both prospective loss costs and operating expenses are covered; and (4) be willing to walk away if the appropriate premium can't be obtained."

According to Buffett, many insurers pass the first three tests and flunk the fourth because they simply can't turn their back on business that competitors are eagerly writing. Berkshire's record in adhering to all the four disciplines seems to be exemplary. It appears to have an independent mindset that a good underwriter needs, exemplified by the personality of Ajit Jain, who looks after Berkshire's Reinsurance operation, the jewel in the crown of Berkshire. In his 2011 annual letter to shareholders, Warren Buffett extolled Ajit Jain's virtues in the following words: "Ajit has created an insurance business with a float of $34 billion and significant underwriting profits. A feat that no CEO of any other insurer has come close to matching. His

operation combines capacity, speed, decisiveness, and most importantly, brains in a manner that is unique to the insurance business … Charlie would gladly trade me for a second Ajit. Alas, there is none."

Mergers, Acquisitions, and Restructuring

Grow Through Acquisitions and Stock Market Purchases Berkshire's approach to business was stated very clearly by Buffett in the 1995 annual report: "Charlie Munger, Berkshire's Vice Chairman and my partner, and I want to build a collection of companies—both wholly- and partly-owned—that have excellent economic characteristics and that are run by outstanding managers. Our favourite acquisition is the negotiated transaction that allows us to purchase 100% of such a business at a fair price. But we are almost as happy when the stock market offers us a chance to buy a modest percentage of an outstanding business at a pro-rata price well below what it would take to buy 100%. This double- barreled approach—purchases of entire business through negotiation or purchases of part-interests through the stock market—gives us an important advantage over capital- allocators who stick to a single course. Woody Allen once explained why eclecticism works: The real advantage of being bisexual is that it doubles your chances of a date on Saturday night."

Apply Stiff Criteria for Acquisitions Berkshire Hathaway has over a period of time made numerous acquisitions successfully. Buffett, aware of potential pitfalls of acquisitions, has exercised considerable discipline in his acquisition programme which is guided by well laid out criteria. As Buffett says: "We prefer (i) large purchases (at least $X million EAT), (ii) demonstrated consistent earning power (future projections are of little interest to us, nor are 'turnaround' situations), (iii) businesses earning good returns on equity while employing little or no debt, (iv) management in place (we can't supply it), (v) simple businesses (if there's lots of technology, we won't understand it), (vi) an offering price (we don't want to waste our time or that of seller by talking, even preliminarily about a transaction when price is unknown). We will not engage in unfriendly transactions. We can promise complete confidentiality and a very fast answer as to possible interest – customarily within five minutes."

Despite clearly spelling out the criteria for acquisitions, Buffett and Munger are approached about acquisitions that don't come close to meeting the above tests. As Buffett puts it, "We've found that if you advertise an interest in buying collies, a lot of people will call hoping to sell you their cocker spaniels. A line from a country song expresses our feeling about new ventures, turnarounds, or auction-like sales: "When the phone doesn't ring, you'll know it's me."

A typical example of Berkshire's acquisitions is its purchase of Lubrizol. On March 14, 2011 (a Monday), Berkshire announced that it would buy Lubrizol for $9 billion in cash. Lubrizol fits much of Buffett's deal making criteria:

- It is a large company which earned $732 million in 2010. Its earnings have been relatively consistent.

- Its products are easy to understand: It makes goods for global transportation, industrial, and consumer markets, including fuel additives for gasoline and diesel.
- It is a global leader in several market applications.
- The management team has been in place for a while.
- It is run by James Hambrick, a talented CEO, who has been with the company from the 1970s.

Buffett said in a statement, "Our only instruction to James—just keep doing for us what you have done so successfully for your shareholders." Berkshire will pay $135 a share for Lubrizol, a specialty chemical maker in Wickliffe, Ohio, 28% above the closing price on Friday. Lubrizol was advised by Citigroup and Evercore on the deal.

Follow a Hands-Off Style After a purchase, Berkshire follows a hands-off style. As Buffett says: "After the purchase, our role is simply to create an environment in which these CEOs and their eventual successors, who typically are like minded, can maximize both their managerial effectiveness and the pleasure they derive from their jobs. With this hands-off style, I am heeding a well-known Mungerism: If you want to guarantee yourself a lifetime of misery, be sure to marry someone with the intent of changing their behaviour."

Do not Sell Any Good Businesses that Berkshire Owns The eleventh Owner-Related Principle of Berkshire says: "You should be aware of one attitude that Charlie and I share that hurts our financial performance. Regardless of price, we have no interest at all in selling any good business that Berkshire owns. We are also very reluctant to sell sub-par businesses as long as we expect them to generate some cash and as long as we feel good about their managers and labour relations. We hope not to repeat the capital-allocation mistakes that led us into such sub-par businesses. And we react with great caution to suggestions that our poor businesses can be restored to satisfactory profitability by major capital expenditures. (The projections will be dazzling and the advocates sincere, but, in the end, major additional investment in a terrible industry usually is about as rewarding as struggling in quicksand.) Nevertheless, the gim rummy managerial behaviour (discard your least promising business at each turn) is not our style. We would rather have our overall results penalized a bit than engage in that kind of behaviour."

In his 2011 Chairman's Letter, Buffett said: "Our approach is far from Darwinian and many of you may disapprove it. I can understand your position. However, we've made – and continue to make—a commitment to the sellers of the businesses we buy that we will retain those businesses through thick and thin. So far the dollar cost of that commitment has not been substantial and may be offset by the goodwill it builds among prospective sellers looking for the right permanent home for their treasured business and loyal associates. These owners know that what they get with us can't be delivered by others and our commitments will be good for many decades to come."

Corporate Governance

Regard Shareholders as Partners Buffett and Munger regard their shareholders as owner-partners and consider themselves as managing partners. Buffett explains this is

his Owners' Manual: "Although our form is corporate, our attitude is partnership. Charlie Munger and I think of our shareholders as owner-partners. Charlie and I hope that you do not think of yourself as merely owning a piece of paper whose price wiggles around daily and that is a candidate for sale when some economic or political event makes you nervous. We hope you instead visualize yourself as a part-owner of a business that you expect to stay with indefinitely, much as you might if you owned a farm or apartment house in partnership with members of your family."

Since Buffett genuinely views his shareholders as owner-partners, he spends a lot of time and effort in communicating with his shareholders through the annual chairman's letter. This letter, personally crafted by Buffett, is regarded as the gold standard of CEO communication. It explains the performance of the company's activities and future prospects. He displays exceptional candour in his communication. As he says: "Our guideline is to tell you the business facts that we would want to know if our positions were reversed. We owe no less… We also believe candour benefits us as managers: the CEO who misleads others in public may eventually mislead himself in private." Given such a rare commitment to honesty and transparency, Buffett has no reservations in admitting his mistakes. In his 1989 annual report he reported his mistakes under the title The mistakes of first 25 years (a condensed version).

His self-assessments are as candid as humorous. In the 1999 annual report of Berkshire Hathaway, Buffett wrote: "My performance reminds me of the quarterback whose report card showed four Fs and a D but who nonetheless had an understanding coach. 'Son, he drawled, 'I think you're spending too much time on one subject.'"

Buffett has assiduously cultivated a genuine owner-oriented culture at Berkshire. As he says: "Our compensation programmes, our annual meetings and even our annual reports are all designed with an eye to reinforcing the Berkshire culture, and making it one that will repel and expel managers of a different bent. This culture grows stronger every year, and it will remain intact long before Charlie and I have left the scene."

Do not Manage Earnings or Provide Earnings Guidance In Berkshire's communications, Buffett states clearly that the company does not "follow the usual practice of giving 'earnings guidance','' recognizing that "reported earnings may reveal relatively little about our true economic performance." Instead Berkshire vows to be "candid in our reporting to you, emphasizing the pluses and minuses important in appraising business value. Our guideline is to tell you the business facts that we would want to know if our positions were reversed. We owe you no less."

Berkshire focuses on long-term cash flows and scrupulously avoids actions designed to boost short-term performance at the expense of long-term value. Buffett explained Berkshire's position in the 2005 annual report: "If a management makes bad decisions in order to hit short-term earnings targets, and consequently gets behind the ball … no amount of subsequent brilliance will overcome the damage that has been inflicted."

Attract and Retain High Quality Owners An important goal at Berkshire is to have its stock sell at a price that mirrors its intrinsic value. The key to this is rational shareholders.

Berkshire strives to achieve high quality ownership by consistently communicating its business and ownership philosophy—without any conflicting signals—and then

relying on the process of self-selection. As Buffett says: "Through our policies and communications—our 'advertisements'—we try to attract investors who will understand our operations, attitudes and expectations (and fully as important, we try to dissuade those who won't). We want those who think of themselves as business owners and invest in companies with the intention of staying a long time."

To attract long-term investors as opposed to short-term speculators, Berkshire has never split its shares. This has contributed to its high per-share price and significantly reduced the liquidity of the stock.[3]

Indeed Berkshire has succeeded admirably in attracting and maintaining high quality shareholders. This is evident from the extremely low turnover in its shares, the enduring loyalty of its shareholders, and the superior quality of its annual general meetings where thoughtful questions are asked by investors. The Berkshire AGM is referred to as the mother of all AGMs. As Warren Buffett says: "We always have bragged a bit on these pages about the quality of our shareholder-partners. Come to the annual meeting and you will see why."

As Buffett says: "I happen to think that by not splitting Berkshire Hathaway stock, we attract a slightly more long-term oriented group of investors. What you want to do is attract shareholders that are very much like you, with the same time horizons and expectations. We don't talk about quarterly earnings, we don't have an investor relations department, and we don't have conference calls with Wall Street analysts, because we don't want people who are focusing on what's going to happen next quarter or even next year."

Engender Board Independence A board is independent when its members are "high-grade people whose interests are in line with those of rank-and-file shareholders- and are in line in a big way." Berkshire has strived to engender board independence. As Warren Buffett wrote in his 2003 Annual Report, "We now have eleven directors and each of them owns more than $ 4 million of Berkshire stock. All eleven directors purchased their holdings in the market just as you did; we've never passed out options or restricted shares. Charlie and I love such honest-to-God ownership. After all, whoever washes a rental car?" He continued "In addition, director fees at Berkshire Hathaway are nominal. Thus, the upside from Berkshire Hathaway for all eleven is proportionally the same as the upside for any Berkshire Hathaway shareholder. And it always will be. The downside for Berkshire Hathaway directors is actually worse than yours because we carry no directors', and officers' liability insurance.

[3]. However, Berkshire has created a Class B stock, with a per-share value originally kept close to 1/30 of that of the original shares (now Class A) and 1/200 of the per-share voting rights. After the January 2010 stock split, the per share value of the Class B stock is 1/1500 of that of Class A shares and its voting rights are 1/10,000 of that of Class A shares. Class A stocks can be converted to Class B stocks, but not vice versa. Buffett reluctantly created Class B shares, in order to thwart the creation of unit trusts that would market themselves as Berkshire look-alikes. As he said in his 1995 letter to shareholders: "The unit trusts that have recently surfaced fly in the face of these goals. They would be sold by brokers working for big commissions, would impose other burdensome costs on their shareholders, and would be marketed en masse to unsophisticated

buyers, apt to be seduced by our past record and beguiled by the publicity Berkshire and I have received in recent years. The sure outcome: a multitude of investors destined to be disappointed."

Engender Board Independence A board is independent when its members are "high-grade people whose interests are in line with those of rank-and-file shareholders- and are in line in a big way." Berkshire has strived to engender board independence. As Warren Buffett wrote in his 2003 Annual Report, "We now have eleven directors and each of them owns more than $ 4 million of Berkshire stock. All eleven directors purchased their holdings in the market just as you did; we've never passed out options or restricted shares. Charlie and I love such honest-to-God ownership. After all, whoever washes a rental car?" He continued "In addition, director fees at Berkshire Hathaway are nominal. Thus, the upside from Berkshire Hathaway for all eleven is proportionally the same as the upside for any Berkshire Hathaway shareholder. And it always will be. The downside for Berkshire Hathaway directors is actually worse than yours because we carry no directors', and officers' liability insurance.

"The bottom line for our directors: You win, they win big; you lose, they lose big. Our approach might be called owner-capitalism. We know no better way to engender true independence. This structure does not guarantee perfect behaviour. I've sat on boards of companies in which Berkshire had huge stakes and remained silent as questionable proposals were rubber-stamped."

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

Do Not Create Inflated Expectations Buffett poses a question like this: "What qualities do you look for in your partner for the marriage to last long? Intelligence, beauty, humour, wealth." He then answers, "low expectation." Taking a cue from this, he does not create inflated expectation in his investors. Periodically, he emphasizes the near-impossibility of repeating the past performance of Berkshire because of its increasing size and growing competition.

Forge an Owner-Oriented Culture Buffett assiduously cultivates an owner-oriented culture. As he put it, "Our final advantage is the hard-to-duplicate culture that permeates Berkshire. And in businesses, culture counts."

"To start with, the directors who represent you think and act like owners. They receive token compensation: no options, no restricted stock and, for that matter, virtually no cash. We do not provide them directors', and officers' liability insurance, a given at almost every other large public company. If they mess up with your money, they will lose their money as well. Leaving my holdings aside, directors and their families own Berkshire shares worth more than $3 billion. Our directors, therefore, monitor Berkshire's actions and results with keen interest and an owner's eye. You and I are lucky to have them as stewards."

Make Long-term Commitments Just the way Buffett strives to attract long-term investors, Berkshire has a policy to make a long-term commitment to businesses and investments. When Berkshire invested in Cap Cities/ABC, Buffett assured that his investment was for long-term, even if the company's problems were not resolved soon.

As Buffett says: "We are not pure economic creatures and the policy penalises our results somewhat, but we prefer to operate that way in life. What's the sense of becoming rich if you're going to have a pattern of operation where you continually discard associations with people you like, admire, and find interesting in order to earn a slightly bigger figure? We like big figures, but not to the exclusion of everything else."

Berkshire's Strengths

According to Buffett, Berkshire's strength is derived from the following:

- An *unmatched collection* of businesses with most of them having favourable economic characteristics.
- A *cadre of outstanding managers*.
- An *extraordinary diversity* of earnings.
- A *preferred buyer* status among many owners and managers who plan to sell their businesses.
- A *culture*, which is very distinct from most large companies, forged assiduously over 50 years.

The Art of Giving: The Buffett Way

Every society would have to find a way to rein in great fortunes for the benefit of the society at large and yet pre
motivation for wealth creation. The growing divide between the super rich and the utterly poor has tarnished the
capitalism as somewhat exploitative, particularly among the poor and the downtrodden and certain se
intelligentsia. The year 2006 witnessed a seminal event in the history of capitalism when Buffett donated the b
considerable wealth to Bill and Melinda Gates Foundation in the largest philanthropic act in the history of
Warren Buffett and Bill Gates have joined hands to promote the 'Pledging Wealth' movement. Many billiona
joined them, including Azim Premji, Shiv Nadar, Nandan Nilekani, and Kiran Majumdar Shaw from India. Hopef
actions will help in elevating capitalism to a more humane level. Apart from the moral and ethical aspects of g
super-rich would do well to get actively involved in philanthropic activities that mitigate the growing income/wea
society and promote a more stable social order.

B. SNIPPETS

1. ASIAN STOCK EXCHANGE HAVE A PREFERENCE FOR AUCTION OR ORDER-DRIVEN MARKET SYSTEM

Stock exchanges in the Asian region China, Japan, India, Korea, Hongkong, Malaysia, Singapore, Taiwan, Thailand and so on), in general have adopted an auction or order-driven market system rather than a dealer or quote- driven market system (as is found in New York Stock Exchange, NASDAQ, and LSE). Several factors explain this pattern:

1. Individual investors play a larger role in Asian markets whereas institutional investors play a larger role is Western markets.
2. The need for low trading costs in Asian markets have dictated the adoption of the order-driven market system.
3. Historically, in Asian societies there is a deep distrust of "deal making," which is associated with a dealer market.
4. It is easier to regulate an order- driven market than a dealer market.

2. PAUL SAMUELSON ON INDEXING

Paul Samuelson: "A thousand to ten thousand money managers all look about equally good or bad. Each expects to do 3% better than the mob. Each has put together a convincing story. After the fact, hardly ten out of ten thousand perform in a way that convinces an experiences student of inductive evidence that a long – term edge over indexing is likely.. It may be the better part of wisdom to forsake search for needless that are so very small in haystacks that are so very large."

Paul Samuelson "The investor who runs a portfolio of five to fifty assets is (usually) being self- indulgent. The hobby can be an expensive one over forty years of the individual's life cycle. Blowing a thousand dollars a year at the gaming tables of Las Vegas might be a comparative bargain, but of course the gratifications to the ego may be less for many temperaments that are not so much desirous of taking risks of proving an ability to beat, life's odds by personal cleverness."

"The Judgment of Economic Science on Rational Portfolio Management: Indexing, Timing & Long – Horizon Effects, *Journal of Portfolio Management* Fall 1989, 4.12

3. MARTIN SORELL ON TECHNICAL ANALYSIS

1. While there is evidence in support of the usefulness of moving averages, momentum, support and resistance and some patterns, there is no convincing evidence in favour of Gann theory or Elliot wave theory.
2. Non- linear methods seem to work better than linear methods. This is not surprising given the non- linearities found in the markets.
3. Technical analysis seems to work best in currency markets and worst in stock markets and in- between in futures markets.

Why do so many people believe in technical analysis? There are some psychological reasons such as communal reinforcement and selective thinking. Communal reinforcement is a social phenomenon when a claim is repeatedly asserted by the members of a community a strong common belief is formed, regardless of the empirical evidence in favour of it. *Selective thinking* is the process by which one focuses on favourable evidence and ignores unfavourable evidence. It is akin to confirmation bias.

4. SUCCESSFUL SECURITY ANALYSIS

Successful security analysis calls for an understanding of four basic dimensions.

1. **Capital markets**: How efficient is the market? How prices are formed in the market? What does the market care about?
2. **Strategic issues**: What is the strategy of the firm? What it is the value chain of the firm? How value is created or destroyed?
3. **Valuation**: What are the pros and cons of various valuation methodologies?
4. **Behavioural finance**: What are the cognitive traps? How does psychology influence financial behavior?

PART C: WIT AND WIDSOM

1.HUMOUR

- A man went to a pet shop to buy a pet who would do some work for him. The shop owner recommended a dog. The man said, “What can a dog do. Suggest some other pet.” The shop owner suggested a cat. The man said, “What can a cat do. Suggest some other pet.” The shop owner said “Take this centipede. It costs less and it does everything.” Reluctantly the man bought it. After reaching home he asked the centipede “Do the dishes.” The centipede did the dishes in just 10 minutes. Next, the man asked the centipede to clean the living room. The centipede did that in just 15 minutes. Amazed, the man asked the centipede to get the newspaper from the corner store. The centipede did not return even in two hours. Concerned, the man opened his door to find where the centipede was. He found it just outside the door. The man said, “Why have you not got the newspaper I asked for two hours back.” The centipede said “I am going .I am going. I am just putting my shoes on.”

- A lawyer is seated next to a blonde on a long flight from London to New York. To pass time, the lawyer asks the blonde whether she would play a fun game with him. Keen on taking a nap, the blonde declines. Persisting, the lawyer says that the game will be a lot of fun and explains how it works: "I will ask you a question, and if you don't know the answer you will have to pay me $10 and vice versa." The blonde declines. To motivate her, the lawyer says "If you don't know the answer you pay me $10, but if I don't know the answer I will pay you $100." Realising that the lawyer will pester her endlessly, the blonde relents. The lawyer asks "What is the population of Alaska? The blonde gives him $10. The blonde asks, "Which is that animal that goes on two legs up the hill but while returning comes on three legs?" and takes a nap. The lawyer searches for the answer on the internet on his laptop for half an hour but can't get the answer. So he gives $100 to the blonde. He then asks the blonde, "Out of curiosity, I want to know what is the answer." The blonde gives him $10 and goes back to sleep.

2. WISE SAWS

- The older you grow the more you realize that kindness is synonymous with happiness.
- A scientist solved the mystery of evolution: we lie between the animal state and civilized state.