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Warren E. Buffett: Entrepreneur, investor, and philanthropist

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ABSTRACT

The life of Warren E. Buffett, the CEO and Chairman of Berkshire Hathaway, has mesmerized people all over the world for decades. Part of Buffett's mystique is how can someone so rich and intelligent can be so humble, gentile and generous. By the time Buffett passes, he will have given $100 billion to charities. Buffett is the J.P. Morgan of our generation by showing great strength and courage through the Great Recession. When the world stopped and was in shock, Buffett spoke with calmness and rationality. This article examines Buffett, Berkshire Hathaway, and his investment methodology. Specifically, the article explores his background, entrepreneurial ventures, college and work experiences, and the people that influenced him. The article examines Buffett's relationship with Benjamin Graham, one of the three people that had the biggest influence on him during his life. The other two being his father, Howard, and his first wife, Susie. After working for Graham on Wall Street, Buffett became a millionaire in today's dollars by age 26. He then moved back to his hometown of Omaha, Nebraska where he founded seven investment partnerships that returned an average annual rate of 30%. After closing his partnerships, Buffett built Berkshire Hathaway into an empire with Charlie Munger, his Vice Chairman. The article then moves into Buffett's investment methodology by examining value investing, margin of safety, and intrinsic valuation.

Key Words: Warren Buffett, Keys to Success, Entrepreneur, Economy, Investments, Berkshire Hathaway, Philanthropy.

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INTRODUCTION

In June 2017, Warren Buffett, the CEO and Chairman of Berkshire Hathaway, oversaw a company that he founded and grew to 367,000 employees. The company had almost $100 billion in cash. Buffett had a personal net worth of around $73.7 billion. He was 86 years old and Charlie Munger, the Vice Chairman of Berkshire, was 93. Using their vast knowledge and experience, Berkshire Hathaway had beaten the S&P 500 index on average by 9.3% from 1964 through 2016. In 2016, Berkshire's net profit was $27.5 billion versus $15.4 billion in 2015. Since 1964, Berkshire's book value per share has grown over 884,319%, compared with a 12,717% gain for the S&P 500 stock index. Tables 1-2, as seen in the Appendix, show the success of Berkshire Hathaway.

BUFFETT'S EARLY YEARS

Buffett's family were entrepreneurs. He was born in Omaha, Nebraska in 1930 and was one of three children of Leila and Howard Buffett. In 1869, Buffett's great grandfather, founded a grocery store in downtown Omaha. The store was taken over by Buffett's uncle and eventually moved closer to Buffett's childhood home in the Dundee area in Omaha.

One of the biggest influences on Buffett's life was the Great Depression. His father was laid off from his job and eventually opened his own stock brokerage firm out of necessity. These early years would have a huge impact psychologically on Buffett for the remainder of his life.

Buffett's life as an entrepreneur blossomed at the age of six. He began his entrepreneurial life selling lemonade on his driveway and then moved on to selling chewing gum and *Coca-Cola* door to door. Buffett had that hustle mentality that entrepreneurs tend to have early in life.

Buffett was also involved in several other entrepreneurial ventures including: paper routes; collecting golf balls from golf courses and reselling them; selling peanuts and popcorn at ball games; collecting winning tickets at the race track that were left on the ground; founding a pinball machine company; buying a used Rolls Royce and then renting it out; and buying real estate and renting it out. Buffett stated, "By the age of 10, I had read every book in the Omaha Public Library with the word finance in the title, some twice" (*Omaha.com*, 2008, p. 88). By the age of 16, Buffett had made $6,000 or $53,000 in today's dollars. Buffett knew from a very young age that he wanted to be rich.

After high school, Buffett was pressured by his father to go to college even though he thought the best thing to do was work and gain experience from his business ventures. Later in life, this would be something that Buffett preached to students from all over the world. Buffett valued business experience more so than reading books. However, due to peer pressure from his father, he attended the Wharton School of Business at the University of Pennsylvania for two years. Buffett complained that oftentimes he knew more than the professors. He transferred to the University of Nebraska at Lincoln where he graduated with a Bachelor of Science degree in 1950 at the age of 19. While he attended Nebraska, he had over 50 people delivering papers for him.

BUFFETT AND GRAHAM

After getting his undergraduate degree, Buffett applied to Harvard at 19 years old. He had a personal interview in Chicago and was told to get some business experience. After he read the *Intelligent Investor* (1949) by Benjamin Graham, Buffett decided that he wanted to study under Graham at Columbia Business School. He sent Graham a letter asking them if he was still alive, and if so, he wanted to study under him. Graham responded with yes and Buffett was admitted to the Master's program at Columbia.

Born, Benjamin Grossbaum (Graham) in 1894 in London, England. Graham, who was Jewish, changed his last name due to strong anti-Semitism. Graham graduated as the salutatorian of his class at Columbia at age 20. He worked on Wall Street after graduating from Columbia and then co-founded his own investment partnership called Graham-Newman.

Graham started teaching at Columbia in 1928. In 1929, he almost went bankrupt during the Great Depression. Thus, Graham was determined to write a book about his experiences while he taught at Columbia. David Dodd, a young instructor, volunteered to take notes. The result was a famous book called *Security Analysis* (1934).

Buffett studied under Graham and Dodd for one year. He earned a Master of Science degree in Economics and was one of Graham's most prized students. Despite being the youngest student in the class, Buffett shined and was the only student ever receive an A+ from Graham. Under Graham, Buffett was exposed to *Security Analysis* (1934) and *The Intelligent Investor* (1949). Buffett stated, "Graham tried to do something foolish, something creative, and something generous every day" (Buffett, 1976).

After graduate school, Buffett applied to Graham's firm and offered to work for free. But Graham rejected his application. He moved back to Omaha and worked as a stockbroker for his father's stock brokerage for five years. During this time frame, Buffett was extremely creative and persistent. He maintained contact with Graham and made several investment recommendations, which would eventually pay off for both Buffett and Graham. When interviewed later in life, Buffett would emphasize that some of the most important keys to success in business are being very creative, not thinking like others, or thinking "way outside of the box" and also being persistent (Finkle, 2010a).

Eventually, Graham hired Buffett and he worked at Graham-Newman from 1954-1956. He started at $12,000 ($107,000 in today's dollars) a year at Graham's Wall Street firm. After his tenure at Graham-Newman (Graham closed the partnership in 1956 due to his retirement), Buffett had amassed a fortune of $1.53 million in today's dollars. Buffett stated that he had enough money to retire at age 26.

BUFFETT'S INVESTMENT PARTNERSHIPS

After Graham closed his investment partnership, Buffett pondered what his next career move should be. Buffett stated that he did not like the questionable behavior of Wall Street. He returned home to Omaha and created his own investment partnership. In 1956, Buffett went back to his roots and decided to become an entrepreneur again. He founded the Buffett Partnership, Limited. According to Buffett, "I will run it like I run my own money. I will take part of the profits and losses but I will not tell you what I am doing" (Finkle, 2010b). The partnership was created with Buffet as the general partner with six other limited partners. Buffett eventually created seven different partnerships. The initial one was called Buffett Associates,

Ltd, which only included friends and family. Buffett contributed only $100 and his six friends and family members contributed $105,000. Buffett created two more partnerships by the end of 1956.

Buffett's office was in a three-story Dutch colonial home that he purchased for $31,500 in 1957 (Buffett still lived in the same house today). The house was adjacent to a busy street, Farnam. Buffett had no office and ran things from a tiny sitting-room off his bedroom with no secretary and no calculator (Kilpatrick, 2008, p. 88).

In April 1958, the fee structure for his partnership was that Buffett would take 25% of the downside. Regarding this structure Buffett once said, "I got half the upside above a four percent threshold, and I took a quarter of the downside myself. So, if I broke even, I lost money. And my obligation to pay back losses was not limited to my capital. It was unlimited" (Schroeder, 2009 p. 179-180).

At age 28, Buffett had 5 partnerships and by age 30 he had 7. These 7 partnerships were worth $7 million of which $1 million was his. During these years, Buffett began his famous letters to partners (see http://www.rbcpa.com/WEB_letters/WEB_Letters_pre_berkshire.html). In these letters, Buffett explained to the partners the performance of the fund, the current investment climate, and moves that he had made in the previous year.

In 1962 Buffett began buying Berkshire Hathaway, a textile manufacturer located in New Bedford, Massachusetts. By 1964 Buffett bought 7% of the company. That same year the management team made an offer for Buffett's shares for $11.50 a share. Buffett agreed to the price, however two weeks later when he received the paperwork it said $11.375. This was one-eighth less than the agreed upon number and made Buffett furious. He was so furious that he ended up buying the whole company. Buffett would later state, "That was probably the biggest investment mistake I ever made". He spent 25% of the partnership's total capital on the acquisition and the company eventually failed in 1985. Munger speculated that his father passed away five days before this occurred and may have influenced Buffett's irrational decision making.

In 1969, Buffett liquidated his partnership and transferred all the assets from his partnership into shares of Berkshire Hathaway, Inc. He gave the partners their shares. Buffett was now going to use Berkshire as a holding company to purchase other companies and investments. At the end of its life of 13 years, the partnership was worth $100 million. The Partnership returned an average annual return of 30% versus 7.4% for the Dow Jones Industrials Average. (Kilpatrick, 2008, p. 16).

BERKSHIRE HATHAWAY, INC.

In 1967 Buffett began diversifying Berkshire Hathaway into the insurance industry. He learned about the value of the insurance industry through Graham. Berkshire's first purchase was the National Indemnity Company. Berkshire later purchased an equity stake in Government Employees Insurance Company (GEICO), which Berkshire eventually bought. One of the keys to Buffett's business success was using the float from the insurance companies Berkshire acquired. He would use this money to fund other investments such as acquisitions.

The float was also known as the available reserve. The float referred to the money paid to Berkshire Hathaway's insurance subsidiaries in premiums but was yet to be paid out to cover any claims. Technically, this money did not belong to the insurance company, but it remained on hand to be invested as its managers saw fit. In 2016, Berkshire Hathaway's float of $91

billion (Buffett, 2017) and was not only one of the largest in the world, but 50 times larger than what it was a generation ago. It allowed Berkshire Hathaway to make quick purchases of temporarily wounded companies and breathe life into them. For example, Berkshire bought Fruit of the Loom for a mere $835 million out of bankruptcy in 2002 after its stock had plunged 97% (*Investopedia.com*, 2014). Over time, Berkshire bought 61 companies and had shares in great companies like American Express, Wells-Fargo, Coca-Cola, Kraft, Burlington Northern Santa Fe (BNSF), Dairy Queen International, Wal-Mart Stores, Inc., Procter & Gamble, Washington Post Company, Wells Fargo & Company, and other public companies.

In February,1996 Buffett allowed stockholders to convert each of their high-priced shares into 30 shares of a new class of stock. The plan created a new Class B common stock, and designated the existing common shares as Class A stock. Class A shareholders could convert their shares into 30 shares of Class B. Once the shares were converted they could not be converted back into Class A. Buffett recommended that they did not recommend their families or friends to purchase B shares. In May 1996, the Class B (Baby Berkshires) shares began trading.

One of Buffett's classic sayings was, "Be greedy when others are fearful". This was originally stated by Graham. During the financial crisis of 2008-2009, Buffett used that philosophy and made $10 billion.

In November 2009, six months after the bottom of the Great Recession, Berkshire bought Burlington Northern Santa Fe Railway for $34 billion (60% cash and 40% stock). When asked why Buffett purchased the company, he chuckled and said, "I always wanted to own my own train company" (Buffett, 2009). When Buffett was a kid he had his own train set. His rationale for purchasing BNSF was the U.S. will continue to grow in the future. The demand for goods and transportation will only go up. BNSF had a durable competitive advantage due to the high cost of entry.

BNSF shareholders had the option to receive either cash or Berkshire shares. Buffett agreed to a 50-to-1 split of Berkshire's high-priced Class B shares. The Class B shares split 50-for-1, or a drop of its share price from $3,300 to $65. That placed the B shares within reach of the common retail investor for the first time.

During the financial crisis, Buffett made deals with Goldman Sachs, Bank of America, Mars, and Dow Chemical. Buffett pumped $5 billion into Goldman Sachs shortly after Lehman Brothers collapsed, a massive boost of confidence in Goldman that shored up its stock price. Buffett bought $5 billion in preferred shares, and as part of the deal Berkshire received warrants for an additional $5 billion worth of common shares. In 2011, Goldman bought back the preferred stock for $5.64 billion, and handed Buffett a $500 million bonus. Buffett exercised the option on 13.1 million common shares for a value of about $2.07 billion (Lobello, 2013).

Buffett hired Todd Combs and Ted Weschler as Co-Chief Investment Officers in 2010 and 2011. He gave each of them a billion-dollar portfolio to separately manage. Buffett has increased their portfolios as he grew more confident in their abilities. By 2017, they were each managing around $10 billion of the total Berkshire stock holdings of $132 billion.

Berkshire Hathaway bought Lubrizol Corporation for $9 billion in cash in March 2011. On February 14, 2013, Berkshire and 3G Capital purchased H.J. Heinz Co. for $28 billion. In 2014, Berkshire agreed to buy Duracell from Procter and Gamble (P&G). In 2016 the deal finalized with P&G investing $1.8 billion in cash into Duracell and Berkshire giving back 52 million shares of P&G that Berkshire obtained when it sold 9% (96 million shares) of the Gillette stock it owned.

In 2015, it was announced that Kraft Foods would merge with HJ Heinz in a deal orchestrated by 3G Capital and Berkshire Hathaway. Berkshire and 3G invested $10 billion in the deal, which valued Kraft at about $46 billion, before net debt, based on its stock price (Giammona & Boyle, 2016). Buffett stated that Berkshire owned $9.5 billion of the new company called HJ Heinz-Kraft Foods company, which was the third largest food and beverage company in North America.

In August 2015, Berkshire Hathaway, Inc. bought Precision Castparts Corporation (PCC) for $32 billion, the largest deal ever done by Berkshire. PCC was the world's premier supplier of aerospace components (most of the components are destined to be original equipment, though spares are important to the company as well). PCC's products, often delivered under multi-year contracts, were key components in most large aircraft. Other industries are served as well by the company's 30,466 employees, who worked out of 162 plants in 13 countries (Buffett, 2015).

In May 2016, Berkshire revealed that it bought $1 billion in Apple, Inc. stock. In February 2017, the company announced that Apple was their second largest holding with 133 million shares worth $17 billion or 2.5% of Apple. Berkshire also owned 81,232,303 shares of IBM or a $14.6 billion stock position. In June 2017, the Class A shares were the highest priced stock listed on the New York Stock Exchange at around $249,330. The B shares were currently trading around $166.

WARREN BUFFETT AND INVESTING

Investment Philosophy

Buffett stated that if you want to become a successful investor you need to read all the time. He suggested that people who want to become successful investors read 500 pages a day. Buffett, himself, reads 80% of the day.

Buffett has stated that the secret to making money was to know your investment and stay within your area of competence and know when to swing at the right pitch. Patience played a big role in his investment philosophy. Buffett stated that you needed to avoid making mistakes. He stated that investors needed to bet big and seldom. However, he also emphasized that no one is perfect and you are bound to make mistakes. Buffett kept his investments secret until the Securities and Exchange Commission (SEC) forced him to disclose his transactions. Buffett had a strong dislike for debt. He had two rules: Rule no 1: never lose money. Rule no 2: never forget rule no 1 (Loiacono, 2010).

Buffett used a value investment methodology that was like Graham's methodology. This entailed discipline, patience, and seeking value oriented investments. Due to Buffett's successful track record, it was not uncommon to see his moves replicated in the markets. Berkshire's strategy was to acquire great businesses that traded at a discount to their intrinsic value and he held them for a long time. Buffett stated, "We want businesses to be ones (a) that we can understand; (b) with favorable long-term prospects; (c) operated by honest and competent people; and (d) available at a very attractive price" (*Gurufocus.com,* 2016).

Buffett stated, "Success in investing does not correlate with I.Q. once you are above the level of 25. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing" (Buffett, 2008). Buffett and Munger never hired any consultants to help them. Buffett stated, "I do not want to buy into any business that I am sure of. It probably is not going to offer any credible returns. Why should something

that is essentially a cinch offer you 40% a year? We do not have huge returns in mind, but what we do have in mind is never losing anything" (Finkle, 2010b, p. 78).

Buffett followed the value investing methodology where one purchased stocks that were undervalued by the marketplace. The problem with this methodology is that there was no one best universal way to value a company. Valuing companies was different depending on the industry and stage of growth. Valuing companies was a competitive advantage that Buffett brought to Berkshire. He seemed to have the magic touch when valuing companies. During a recent luncheon, someone asked him, "What is the best way to value a company?" Buffett simply stated the discounted cash flow (DCF) method. The problem with this is there were different methods to using the DCF model.

It was not uncommon for Buffett to follow a company's management team and performance over several years before he would invest in a company (Finkle, 2010b, p. 79). Buffett stated several times that business education was highly overvalued. He also stated that he did not believe in the Efficient Market Hypothesis, which was taught at most business schools. Buffett stated that these schools have you taking these different classes, when all you need to know to become a successful investor is two courses: (1) A course on how to value companies and (2) A course on human behavior in the markets (Finkle, 2010b, p. 79).

At the 2016 Berkshire Hathaway Shareholder's Meeting, Buffett spoke negatively about Wall Street. He stated that they want the retail investor to trade so they can make money off them. Buffett stated that if you do not have the time or expertise to do research on individual stocks, the best thing for you to do is to put 90% of your money in a low-cost S&P 500 index fund and 10% into a short-term bond fund. After his death, that's how he wanted his money managed. Buffett also stated that you should leave your investments there forever and do not trade. Wall Street wants you to trade because they make money on you. Buffett also emphasized not listen to what the talking heads on television tell you. No one can predict what will happen in one day, one week, or one year (Buffett, 2016). However, over time, the markets tend to go up. Every 100 years we tend to have 15 bad years.

During the 2016 Shareholder's Meeting, Buffett updated everyone on his million-dollar bet that he made with Protégé Partners, a New York hedge fund in 2006. The bet was initiated by Protégé Partners, that over a decade, the cumulative returns of five fund of funds (Hedge Funds) picked by Protege, even after including fees, would outperform the S&P 500 stock index. At the end of nine years, the S&P 500 index was 85.4% and Hedge Funds were 22%. Every year Buffett put up the numbers, the shareholders would roar with laughter.

In an interview in February 2017, Buffett stated that it was a good time to invest in the markets due to low interest rates. He also gave some valuable advice to retail investors. He estimated that retail investors have lost over $100 billion in fees the past decade by hiring investment managers that for the most part cannot even beat the S&P 500 index.

In 2016, Cox (2017) reported that only 19% of active large cap managers beat the Russell 1000. Buffett stated that if you do not work in the investment industry, you are not going to beat the indexes. Buffett has long held that hedge funds and investment managers who actively managed others' money provided few real benefits. That's because hedge funds and other money managers often charged fees on a "2-and-20" basis, taking 2% as a management fee and 20% of profits. Buffett stated that if he had a similar arrangement with his two investment managers, Todd Combs and Ted Weschler, "They would be getting $180 million each merely for breathing." That compensation scheme was "unbelievable to Buffett," and he added that was

one reason why he made his hedge fund bet. Buffett's point was that passive, unmanaged or "no energy" investments can do just as well, or better than "hyperactive" (Holm & Das, 2016).

Value Investing

According to Buffett, "The two most important essays ever written on investments were written by Benjamin Graham in his book *Intelligent Investor* in Chapter 8 on the attitude towards stock market fluctuations and Chapter 20 on the margin of safety.

Buffett has stated that he has been doing the same thing since he was 19 years old when he first read the *Intelligent Investor.* According to Graham, "Value investing is based more in philosophy than on theorems. There is no step one, step two, step three. The disciplined investor does not follow the crowd but instead searches for stocks selling for less than their intrinsic value and then waits for the market to recognize and correct the disparity" (Graham & Dodd, 1934). They explain that it was extremely difficult to determine the intrinsic value of a security, but one only had to determine whether the security was significantly overvalued or undervalued. Graham & Dodd (1934) emphasize the importance of doing your own research and thinking for yourself due to all the noise (e.g., fraud, scams, misleading information) on Wall Street.

Buffett (1987) described what Graham said in a lecture in the 1987 Annual Letter to Berkshire Hathaway Shareholders, "Mr. Market has an endearing characteristic: He does not mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow. Transactions are strictly at your option. Under these conditions, the more manic-depressive his behavior, the better for you. But, like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find useful. If he shows up someday in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence. Indeed, if you are not certain that you understand and can value your business far better than Mr. Market, you do not belong in the game. As they say in poker, "If you have been in the game 30 minutes and you do not know who the patsy is, you are the patsy."

Buffett (1991) discussed the valuation of firms within the media industry. "A few years ago, the conventional wisdom was that a newspaper, television or magazine property would forever increase its earnings at 6% or so annually and would do so *without the employment of additional capital*, since depreciation charges would roughly match capital expenditures and working capital requirements would be minor. Therefore, reported earnings (before amortization of intangibles) were also freely-distributable earnings, which meant that ownership of a media property could be construed as akin to owning a perpetual annuity set to grow at 6% a year. Say, next, that a discount rate of 10% was used to determine the present value of that earnings stream. One could then calculate that it was appropriate to pay a whopping $25 million for a property with current after-tax earnings of $1 million. [1/0.1-0.06]. (This after-tax multiplier of 25 translates to a multiplier on pre-tax earnings of about 16.)

Now change the assumption and posit that the $1 million represents "normal earning power" and that earnings will bob around this figure cyclically. A "bob-around" pattern is indeed the lot of most businesses, whose income stream grows only if their owners are willing to commit more capital (usually in the form of retained earnings). Under our revised assumption, $1 million of earnings, discounted by the same 10%, translates to a $10 million valuation. Thus,

a seemingly modest shift in assumptions reduces the property's valuation to 10 times after-tax earnings (or about 6 1/2 times pre-tax earnings).

Dollars are dollars whether they are derived from the operation of media properties or of steel mills. What in the past caused buyers to value a dollar of earnings from media far higher than a dollar from steel was that the earnings of a media property were expected to constantly grow (without the business requiring much additional capital), whereas steel earnings clearly fell in the bob-around category. Now, however, expectations for media have moved toward the bob-around model. And, as our simplified example illustrates, valuations must change dramatically when expectations are revised."

Margin of Safety

One of the keys to value investing was the notion of margin of safety. Margin of safety was a principle of investing in which an investor only purchased securities when the market price was significantly below its intrinsic value. In other words, when the market price was significantly below your estimation of the intrinsic value, the difference was the margin of safety. This difference allowed an investment to be made with minimal downside risk. Margin of safety did not guarantee a successful investment, but it did provide room for error in an analyst's judgment. Determining a company's "true" worth (its intrinsic value) was part art and science. Investors had different ways of calculating intrinsic values which may or may not be correct. Plus, it was notoriously difficult to predict a company's earnings. Margin of safety provided a cushion against errors in calculation (*Investopedia.com,* 2016).

According to Buffett, the three most important words in investing were margin of safety. Buffett stated, "Look for margin of safety and look for stocks that were undervalued. I have no idea what the stock market is going to do. It is something that I never think about at all. But I am looking for the stock to go down so I can buy it on sale. I want the stocks to go down, way down so I can make better buys" (Finkle, 2010b, p. 79).

Investment Decisions

After his partnership days, Buffett increasingly used other metrics to evaluate potential investments. After Munger joined Berkshire Hathaway, their attitude was slanted more so towards finding great companies for the long run at good valuations. They changed from merely looking at the quantitative measures of a company (Graham) to both qualitative and quantitative. Buffett used the Discounted Cash Flow (DCF) Model of valuing companies. He typically preferred at least a 15% return on equity on his investment as he wants to double his money every five years. Additionally, he sought out investments with a margin of safety anywhere from 25% to 50% depending on the situation. Below are the qualitative and quantitative factors that Buffett used to evaluate before investing in a company.

Qualitative Factors

These were the qualitative factors that Buffett looked for in his investment opportunities. Management Team: It was not uncommon for Buffett to follow a company's management team and performance over several years before he would invest in a company. He wanted a quality, ethical management team with passion. For example, in 1983 Buffett purchased the Nebraska

Furniture Mart. At the time, it was the largest furniture store in the U.S. Buffett purchased the company from the founder, Rose Blumkin (also called Mrs. B), with a handshake and $55 million. It was evident that Buffett not only respected Mrs. B., but trusted her as he did the deal on a handshake. He knew that she was open and honest and could trust her. These were valuable characteristics that he admired. Blumkin came to the U.S. from Russia in 1917 with $66 and no knowledge of English. She learned English from her five-year-old daughter and in 1937 she started her store in the basement of her husband's pawn shop in Omaha. Blumkin's motto was to be honest and sell cheap.

Buffett also looked-for honesty. He thought that most annual reports were bogus. He valued management that was open and honest with its shareholders. It was not uncommon for Buffett to talk about his mistakes in his annual shareholder letters.

Buffett also wanted to know what a company did with its retained earnings. Does it reinvest its retained earnings? This would make sense if the return was above its cost of capital. Does it dole out dividends? If a firm cannot earn earnings above the cost of capital, Buffett prefers the company to either return the funds to shareholders through dividends or buy back their stock (If it is undervalued). All of this is contingent on the stage in the life cycle of the company. During startup, a company loses money and growth it has positive cash flow but may need money to grow. During the mature and declining stage are more so where the firm needs to determine how to allocate the excess cash on hand. Does the management team think like lemmings? Buffett wanted management to think creatively and independently, without following the trends.

Buffett wanted to make sure that the business was easy to understand and analyze. He only liked businesses that he could understand. Buffett's philosophy was to make sure that the business was easy to understand and analyze. He only liked businesses that he could understand.

One of the keys to his investment success was talking to CEOs in an industry he was interested in investing in. He would ask a CEO if there was one company in your industry you would invest in, who would it be and why? This gave Buffett insight into the industry.

Berkshire's strategy was to acquire great businesses that traded at a discount to their intrinsic value and he held them for a long time. Buffett stated, "We want businesses to be ones (a) that we can understand; (b) with favorable long-term prospects; (c) operated by honest and competent people; and (d) available at a very attractive price". Moat: Does the company have a "sustainable competitive advantage" or a moat? This could be trade secrets like the formula of Coca-Cola or the ingredients of KFC. It could also be a combination of proprietary technology and/or brand/trademarks and/or patents/copyrights. Amazon.com has all three of these: Brand, proprietary technology. Patents, and copyrights. Nike's branding and patents allow it to charge premium prices. Many of the drug companies have patents on drugs, which allows them to reap huge rewards. Gillette has little competition, strong branding, and patents that allow it to charge premium prices.

Quantitative Factors

Some of the quantitative factors that Buffett looks for in his investment opportunities include: Is the company in an industry with good economics, i.e., not an industry competing on price? Does the company have a consumer monopoly within their industry (e.g., Gillette, Coke, Dairy Queen, etc.)? Coca-Cola and Dairy Queen have what Buffett called a moat, where the resources necessary to overcome the brands are enormous. He also liked to compare the company

with other firms within their industry. There was one exception, the last year of evaluation. The company may have had a bad year, which may mean a potential investment opportunity. Buffett used certain quantitative measures to get an idea of whether a firm had the right numbers. Two of those measures were return on equity and return on total capital. Did the company have a high return on equity (ROE= Net Income/Shareholders' Equity)? Buffett preferred 15%, but was willing to go lower depending on the economic conditions. D/E=Total Liabilities/Shareholders' Equity: Was the company's debt-to-equity ratio low enough so the company can pay its debt obligations? Can the company repay debt within five years or sooner based on their current earnings? Profit Margins=Net Income/Net Sales: How old was the company and are its profit margins high? Buffett liked to look at a 10-year track record of financial statements with increasing earnings. A high profit margin indicated the company was executing its business well, but increasing margins meant management had been extremely efficient and successful at controlling expenses. Free Cash Flow: Did the company have consistent strong free cash flow to maintain its current operations?

Other financial aspects included the following: Capital: Buffett preferred firms that did not require a great deal of capital. The business should not have a high maintenance cost of operations, high capital expenditure or investment cash outflow. This was not the same as investing to expand capacity. For example, in 1972, Berkshire bought See's Candies, who had a $4 million pre-tax profit for $25 million. Buffett stated that Berkshire never hired a consultant; their idea was to go out and buy a box of candy and see if they liked it. Buffett purchased the company with the idea that Berkshire could raise the prices of the candy without investing a great deal in capital. Inflation: Was the company free to adjust prices for inflation and still maintain profitability? Retained Earnings: Will the value added by retaining earnings lead to an increase in the stock market value of the company? How did the firm's management spend the company's retained earnings—that is, the earnings a company keeps rather than paying out in dividends. Take the amount a company's earnings per share have increased in the past decade and divides it by the total amount of retained earnings over that time. The result shows how much profit the company generated using the money it has reinvested in itself—in other words, how well management was using retained earnings to increase shareholder value. Buffett required a firm to have generated a return of 12% or more on its retained earnings over the past decade (Reese, 2011). Valuation: Is the stock currently undervalued by at least 25% if not higher? Finding companies that meet the other criteria is one thing, but determining whether they are undervalued is the most difficult part of value investing, and it was Buffett's most important skill. To check this, an investor must determine a company's intrinsic value by analyzing a number of business fundamentals including earnings, revenues and assets. Once Buffett determined the intrinsic value of the company as a whole, he compared it to its current market capitalization - the current total worth (price). If his intrinsic value measurement was at least 25% higher than the company's market capitalization, Buffett saw the company as one that had value. Buffett's success depended on his unmatched skill in accurately determining this intrinsic value (*Investopedia.com,* 2016).

In Berkshire Hathaway's 2007 Shareholder Letter (see Buffett, 2008), Buffett discussed what BH looked for before it invested in a business. Buffett also discussed what they avoided.

"Charlie and I look for companies that have a) a business we understand; b) favorable long-term economics; c) able and trustworthy management; and d) a sensible price tag. We like to buy the whole business or, if management is our partner, at least 80%. When control-type purchases of quality aren't available, though, we are also happy to simply buy small portions of great businesses

by way of stock market purchases. It's better to have a part interest in the Hope Diamond than to own all a rhinestone.

A truly great business must have an enduring "moat" that protects excellent returns on invested capital. The dynamics of capitalism guarantee that competitors will repeatedly assault any business "castle" that is earning high returns. Therefore, a formidable barrier such as a company's being the low-cost producer (GEICO, Costco) or possessing a powerful world-wide brand (Coca-Cola, Gillette, American Express) is essential for sustained success. Business history is filled with "Roman Candles," companies whose moats proved illusory and were soon crossed.

Our criterion of "enduring" causes us to rule out companies in industries prone to rapid and continuous change. Though capitalism's "creative destruction" is highly beneficial for society, it precludes investment certainty. A moat that must be continuously rebuilt will eventually be no moat at all.

Additionally, this criterion eliminates the business whose success depends on having a great manager. Of course, a terrific CEO is a huge asset for any enterprise, and at Berkshire we have an abundance of these managers. Their abilities have created billions of dollars of value that would never have materialized if typical CEOs had been running their businesses.

But if a business requires a superstar to produce great results, the business itself cannot be deemed great. A medical partnership led by your area's premier brain surgeon may enjoy outsized and growing earnings, but that tells little about its future. The partnership's moat will go when the surgeon goes. You can count, though, on the moat of the Mayo Clinic to endure, even though you can't name its CEO.

Long-term competitive advantage in a stable industry is what we seek in a business. If that comes with rapid organic growth, great. But even without organic growth, such a business is rewarding. We will simply take the lush earnings of the business and use them to buy similar businesses elsewhere. There's no rule that you must invest money where you've earned it. Indeed, it's often a mistake to do so: Truly great businesses, earning huge returns on tangible assets, can't for any extended period reinvest a large portion of their earnings internally at high rates of return.

Let's look at the prototype of a dream business, our own See's Candy. The boxed-chocolates industry in which it operates is unexciting: Per-capita consumption in the U.S. is extremely low and doesn't grow. Many once-important brands have disappeared, and only three companies have earned more than token profits over the last forty years. Indeed, I believe that See's, though it obtains the bulk of its revenues from only a few states, accounts for nearly half of the entire industry's earnings.

At See's, annual sales were 16 million pounds of candy when Blue Chip Stamps purchased the company in 1972. (Charlie and I controlled Blue Chip at the time and later merged it into Berkshire). Last year See's sold 31 million pounds, a growth rate of only 2% annually. Yet its durable competitive advantage, built by the See's family over a 50-year period, and strengthened subsequently by Chuck Huggins and Brad Kinstler, has produced extraordinary results for Berkshire.

We bought See's for $25 million when its sales were $30 million and pre-tax earnings were less than $5 million. The capital then required to conduct the business was $8 million. (Modest seasonal debt was also needed for a few months each year.) Consequently, the company was earning 60% pre-tax on invested capital. Two factors helped to minimize the funds required for operations. First, the product was sold for cash, and that eliminated accounts receivable. Second, the production and distribution cycle was short, which minimized inventories.

Last year See's sales were $383 million, and pre-tax profits were $82 million. The capital now required to run the business is $40 million. This means we have had to reinvest only $32 million since 1972 to handle the modest physical growth – and somewhat immodest financial growth – of the business. In the meantime, pre-tax earnings have totaled $1.35 billion. All of that, except for the $32 million, has been sent to Berkshire (or, in the early years, to Blue Chip). After paying corporate taxes on the profits, we have used the rest to buy other attractive businesses. Just as Adam and Eve kick-started an activity that led to six billion humans, See's has given birth to multiple new streams of cash for us. (The biblical command to "be fruitful and multiply" is one we take seriously at Berkshire.)

There aren't many See's in Corporate America. Typically, companies that increase their earnings from $5 million to $82 million require, say, $400 million or so of capital investment to finance their growth. That's because growing businesses have both working capital needs that increase in proportion to sales growth and significant requirements for fixed asset investments.

A company that needs large increases in capital to engender its growth may well prove to be a satisfactory investment. There is, to follow through on our example, nothing shabby about earning $82 million pre-tax on $400 million of net tangible assets. But that equation for the owner is vastly different from the See's situation. It's far better to have an ever-increasing stream of earnings with virtually no major capital requirements. Ask Microsoft or Google.

One example of good, but far from sensational, business economics is our own FlightSafety. This company delivers benefits to its customers that are the equal of those delivered by any business that I know of. It also possesses a durable competitive advantage: Going to any other flight-training provider than the best is like taking the low bid on a surgical procedure.

Nevertheless, this business requires a significant reinvestment of earnings if it is to grow. When we purchased FlightSafety in 1996, its pre-tax operating earnings were $111 million, and its net investment in fixed assets was $570 million. Since our purchase, depreciation charges have totaled $923 million. But capital expenditures have totaled $1.635 billion, most of that for simulators to match the new airplane models that are constantly being introduced. (A simulator can cost us more than $12 million, and we have 273 of them.) Our fixed assets, after depreciation, now amount to $1.079 billion. Pre-tax operating earnings in 2007 were $270 million, a gain of $159 million since 1996. That gain gave us a good, but far from See's-like, return on our incremental investment of $509 million.

Consequently, if measured only by economic returns, FlightSafety is an excellent but not extraordinary business. Its put-up-more-to-earn-more experience is that faced by most corporations. For example, our large investment in regulated utilities falls squarely in this category. We will earn considerably more money in this business ten years from now, but we will invest many billions to make it.

Now let's move to the gruesome. The worst sort of business is one that grows rapidly, requires significant capital to engender the growth, and then earns little or no money. Think airlines. Here a durable competitive advantage has proven elusive ever since the days of the Wright Brothers. Indeed, if a farsighted capitalist had been present at Kitty Hawk, he would have done his successors a huge favor by shooting Orville down.

The airline industry's demand for capital ever since that first flight has been insatiable. Investors have poured money into a bottomless pit, attracted by growth when they should have been repelled by it. And I, to my shame, participated in this foolishness when I had Berkshire buy U.S. Air preferred stock in 1989. As the ink was drying on our check, the company went into a tailspin, and before long our preferred dividend was no longer being paid. But we then got very

lucky. In one of the recurrent, but always misguided, bursts of optimism for airlines, we were able to sell our shares in 1998 for a hefty gain. In the decade following our sale, the company went bankrupt. Twice.

To sum up, think of three types of "savings accounts." The great one pays an extraordinarily high interest rate that will rise as the years pass. The good one pays an attractive rate of interest that will be earned also on deposits that are added. Finally, the gruesome account both pays an inadequate interest rate and requires you to keep adding money at those disappointing returns."

PHILANTHROPY

Ninety-nine percent of Buffett's fortune is going back to society through five different foundations. Most of the money is going to the Bill & Melinda Gates Foundation. However, a few years ago, Buffett gave each of his children, Susie, Howard, and Peter, $2 billion each to create their own charity.

Each of his children focuses on a wide variety of areas. Howard Buffett is the Chairman of the Howard G. Buffett Foundation that focuses on agriculture, nutrition, water, humanitarian, conservation and conflict issues. Susie Buffett is the head of the Susan Thompson Buffett Foundation that primarily focuses on education. Peter Buffett, who was on Barron's list of the most effective philanthropists in 2009 and 2010, is the head of NoVo Foundation. The NoVo Foundation is involved in a number of areas including adolescent girl's rights, violence against women, social and emotional learning, and supporting indigenous communities in North America.

The last foundation Buffett is involved with is called Glide. The Glide Foundation is located in San Francisco and focuses on helping the homeless and needy. Buffett auctions off a lunch with himself every year to support Glide. The winning bid was over $3.6 million in 2016.

It must be noted that Buffett does non-monetary charity activities as well. He invites approximately 40 universities to Omaha every year to share his wisdom about business and life. He has said that if he was not an investor he would be a teacher.

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Appendix: Table 1: List of Companies that Berkshire Hathaway owned as of 12/31/2016

No	Company	No	Company
1	Acme Brick Company	32	H.H. Brown Shoe Group
2	Applied Underwriters	33	HomeServices of America
3	Ben Bridge Jeweler	34	International Dairy Queen, Inc.
4	Benjamin Moore & Co.	35	IMC International Metalworking Companies
5	Berkshire Hathaway Automotive	36	Johns Manville
6	Berkshire Hathaway Energy Company	37	Jordan’s Furniture
7	Berkshire Hathaway Homestate Companies	38	Justin Brands
8	Berkshire Hathaway Specialty Insurance	39	Kraft Heinz
9	BH Media Group	40	Larson-Juhl
10	BoatU.S.	41	Louis – Motorcycle & Leisure
11	Borsheims Fine Jewelry	42	Lubrizol Corporation
12	Brooks	43	Marmon Holdings, Inc.
13	Buffalo NEWS, Buffalo NY	44	McLane Company
14	BNSF	45	Medical Protective
15	Business Wire	46	MiTek Inc.
16	Central States Indemnity Company	47	National Indemnity Company
17	Charter Brokerage	48	Nebraska Furniture Mart
18	Clayton Homes	49	NetJets®
19	CORT Business Services	50	Oriental Trading Company
20	CTB Inc.	51	Pampered Chef®
21	Duracell	52	Precision Castparts Corp.
22	Fechheimer Brothers Company	53	Precision Steel Warehouse, Inc.
23	FlightSafety	54	RC Willey Home Furnishings
24	Forest River	55	Richline Group
25	Fruit of the Loom Companies	56	Scott Fetzer Companies
26	Garan Incorporated	57	See's Candies
27	Gateway Underwriters Agency	58	Shaw Industries
28	GEICO Auto Insurance	59	Star Furniture
29	General Re	60	TTI, Inc.
30	Guard Insurance Group	61	United States Liability Insurance Group
31	Helzberg Diamonds	62	XTRA Corporation

Source: Berkshire Hathaway, Inc. Subsidiaries: Retrieved from
http://www.berkshirehathaway.com/subs/sublinks.html

Appendix: Table 2: Comparison of the Performance of Berkshire's stock versus the S&P 500: 1965-2016

Years	Annual Percentage Change		
	In per-share book value of Berkshire (1)	In S&P 500 with dividends included (2)	Relative results (1)-(2)
1965	23.8	10.0	13.8
1966	20.3	(11.7)	32.0
1967	11.0	30.9	(19.9)
1968	19.0	11.0	8.0
1969	16.2	(8.4)	24.6
1970	12.0	3.9	8.1
1971	16.4	14.6	1.8
1972	21.7	18.9	2.8
1973	4.7	(14.8)	19.5
1974	5.5	(26.4)	31.9
1975	21.9	37.2	(15.3)
1976	59.3	23.6	35.7
1977	31.9	(7.4)	39.3
1978	24.0	6.4	17.6
1979	35.7	18.2	17.5
1980	19.3	32.3	(13.0)
1981	31.4	(5.0)	36.4
1982	40.0	21.4	18.6
1983	32.3	22.4	9.9
1984	13.6	6.1	7.5
1985	48.2	31.6	16.6
1986	26.1	18.6	7.5
1987	19.5	5.1	14.4
1988	20.1	16.6	3.5
1989	44.4	31.7	12.7
1990	7.4	(3.1)	10.5
1991	39.6	30.5	9.1
1992	20.3	7.6	12.7
1993	14.3	10.1	4.2
1994	13.9	1.3	12.6
1995	43.1	37.6	5.5
1996	31.8	23.0	8.8
1997	34.1	33.4	0.7
1998	48.3	28.6	19.7
1999	0.5	21.0	(20.5)
2000	6.5	(9.1)	15.6
2001	(6.2)	(11.9)	5.7
2002	10.0	(21.1)	31.1
2003	21.0	28.7	(7.7)
2004	10.5	10.9	(0.4)
2005	6.4	4.9	1.5
2006	18.4	15.8	2.6

2007	11.0	5.5	5.5
2008	(9.6)	(37.0)	27.4
2009	19.8	26.5	(6.7)
2010	13.0	15.1	(2.1)
2011	4.6	2.1	2.5
2012	14.4	16.0	(1.6)
2013	18.2	32.4	(14.2)
2014	8.3	13.7	(5.4)
2015	6.4	1.4	5.0
2016	10.7	12.0	(1.3)
Compounded Annual Gain – 1965-2016	19.0	9.7	9.3
Overall Gain – 1964-2016	844,319%	12,717%	831,602%

Notes: Data are for calendar years with these exceptions: 1965 and 1966, year ended 9/30; 1967, 15 months ended 12/31. Starting in 1979, accounting rules required insurance companies to value the equity securities they hold at market rather than at the lower of cost or market, which was previously the requirement. In this table, Berkshire's results through 1978 have been restated to conform to the changed rules. In all other respects, the results are calculated using the numbers originally reported. The S&P 500 numbers are pre-tax whereas the Berkshire numbers are after-tax. If a corporation such as Berkshire were simply to have owned the S&P 500 and accrued the appropriate taxes, its results would have lagged the S&P 500 in years when that index showed a positive return, but would have exceeded the S&P 500 in years when the index showed a negative return. Over the years, the tax costs would have caused the aggregate lag to be substantial.

Source: *Berkshire Hathaway's 2016 Annual Report.* Retrieved from http://www.berkshirehathaway.com/2016ar/2016ar.pdf

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