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Insights from Omaha

Along with an exclusive club of 19,000 other shareholders, I journeyed to that mid west Mecca, Omaha on the weekend of May 1, 2004 for the Berkshire Hathaway annual meeting. Rather than a stuffy business meeting, the annual conclave has been properly dubbed the "Woodstock of Investing". In fact a contingent of cheerful Australians, some 50 strong, sported caps with just this phrase! Such is the veneration in which Warren Buffet, Chairman and Charles T. Munger Co-Chairman[1] are held, that I was forced to queue up with thousands of others outside Qwest Convention Center before the doors opened at 7 AM. I had expected a somewhat older group of high net worth folks, understated wealth, if you will (such people do represent a significant portion of Berkshire holders), but it was a more heterogeneous group than I had imagined, with ages ranging from teenagers to octogenarians. It was amusing to see these otherwise dignified folks charging for a suddenly opened door to the meeting in a frenzy to grab a good seat!

After the formal part of the meeting ends, any shareholder can approach the microphone to ask questions of the two Chairmen. Warren and Charlie sit at a small table, side by side on the stage and for nearly six hours, take on every question imaginable. The inquiries ranged from the ridiculous (had they tried organic food?) to the sublime (one fellow tried to analyze the intrinsic worth of the Berkshire Hathaway while standing at his microphone and asking Warren and Charlie to confirm the assumptions included in his valuation model). Despite having read a lot about Buffet, and studied his writings and those who influenced him, I was surprised at some new insights gained. May I share a few with you?

ITPS – "It's the People, Silly"

Buffet & Co doesn't just buy a good business, they believe that what makes a business good is mostly the people who run it. Sure, it is always nice to own a "wide moat" business, one that does not have much competition due to unique patents, or barriers to competition such as high start up costs for competitors. But even a wide moat will not protect a company from bad management. Conversely, take a business with loads of competition such as furniture sales. In the early 1980's Buffet recognized that a local store called "Nebraska Furniture Mart" was doing something exciting, and that this excitement was almost entirely attributable to the founder, Mrs. Rose Blumkin. Mrs. Blumkin a native of Minsk, Russia founded the store in 1937 with $500 of borrowed capital. She grew the business in spite of many challenges including the Depression, World War II, lawsuits from furniture manufacturers[2] and a tornado that destroyed most of the store. What Blumkin was able to do was to stay away from debt and work on a very small mark-up. She undersold her competition to the point where people would drive hundreds of miles to shop at her store. Today, Nebraska Furniture Mart has a 70% share of furniture sales in Nebraska[3] and is growing in the mid teens annually!! Mrs. Blumkin sold a controlling interest in the store to Berkshire Hathaway in 1983 in a tax free exchange. She was age 87 at the time and lived to 104 (still selling furniture!). The business continues to thrive under the watchful eyes of

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her son and grandsons, and they just opened a huge store in Kansas City. When I say the prices are so good it is difficult not to buy, I'm talking from experience. Eileen and I just purchased a new mattress at what we thought was a good price from Costco. I saw the same mattress for 35% less while visiting the NFM exhibit at Berkshire's annual meeting (sound of author kicking himself).

Warren and Charlie's ability to size up people, the qualitative aspect of investment research, is an art not easily taught in business schools. They have repeatedly purchased privately held companies from their founders, with the understanding that they will continue to manage the operation after purchase. When people sell a portion of their business to Berkshire Hathaway (usually the seller retains minority ownership) their motivation is not to take the money and run. Often the creator of a closely held business understands that having aged, they need to create an asset that can be easily passed on to heirs who may have no interest in running the business. Usually the seller receives substantial shares of Berkshire Hathaway stock, publicly traded and easily passed on to spouse and children.

For publicly traded sellers the motivation to sell may be rooted in a desire to escape the pressure of being a publicly traded company (i.e. GEICO) with it's continual government filings, analyst meetings and public relations obligations. A refrain heard from many of Buffet's operating company CEO's is gratitude that they can focus on running the business, rather than "selling" it to Wall Street analysts.

Buffet and Munger take a hands off approach with most of the businesses they have assembled under the Berkshire conglomerate. They feel that the people who sold to them did an excellent job of building a going concern and should be left to operate it as before.

Financial Strength

Berkshire's ownership lends strength to a successful acquisition via it's bullet proof financial strength. With some $30 Billion plus of liquid assets Berkshire is one of only a handful of U.S. corporations with an "AAA" credit rating from all the major agencies. This means that if one of the operating companies wants funds to expand a successful new business line, they do not need to dress up their balance sheet, or smooth earnings so as to look good to Wall Street investment bankers. They do need to talk to Buffet, who tends to be supportive of his managers. A prime example of where this financial strength has provided a competitive advantage is Berkshire Reinsurance, created from two acquired predecessor companies. When there is an unusually large risk that needs to be insured, traditional insurance companies look to sell off interests in a specific policy to other companies. This allows them to spread the risk across a number of firms, reducing the possibility that a large claim would bankrupt a single insurer. Berkshire is often the first stop for others seeking to "re-insure" a specific risk. Often Berkshire takes on the entire risk itself, and is probably the only U.S. insurer who has the financial ability to do so.

In 2000 when the Texas Rangers baseball team signed Alex Rodriguez to a $250,000,000 multi-year contract, they sought insurance against the possibility that Rodriguez would become disabled. Berkshire underwrote the entire policy, and earned a fat premium to do so. Reinsurance is very lucrative, when there are no claims paid out, but periodically, as every one can imagine, a large claim will come along, and for that year, eanings will be hurt. Berkshire Reinsurance is not afraid of producing "lumpy" earnings, because unlike Wall Street analysts and institutional investors, Buffet and Munger understand the volatile nature of reinsurance. Most publicly traded insurers fear unpredictability, and therefore they shy away from a very profitable line of insurance underwriting.

Berkshire's financial strength extends beyond the insurance underwriting opportunities it creates. Buffet gets offered opportunities to buy some of the best businesses in the world because potential sellers know that Berkshire has the money and can move fast to close a deal.

"…temperament is all important"
-(Charlie Munger)

Patience and Discipline are part of what Buffet and Munger refer to as the "right temperament". Few investors have these traits. In ascribing success to certain character traits, Munger downplayed the importance of I.Q. : "It's not a business that requires extraordinary intellect. It does require extraordinary discipline" Discipline is the willingness to walk away from an investment that fails to meet key criteria, despite the herd mentality of Wall Street hucksters and popular business press (think Dot Com frenzy). Patience is a willingness to do nothing for months on end if good opportunities do not present themselves.

These two traits were already familiar to me, after thirty years of testing. But an "ah ha" hit me when Charlie Munger expounded upon the willingness of Berkshire to commit a significant amount of funds to a truly outstanding investment purchase. While the Berkshire boys are extremely patient and disciplined in their search for companies to buy, once convinced that a unique opportunity stands before them, they will commit a large portion of their portfolio. To my great surprise, Munger referred to the notion of portfolio diversification as "conventional madness". This opinion is apparently shared by Lou Simpson[4], who invests over 2.5BB for GEICO. Both Buffet and Simpson own fewer than ten publicly traded firms at any one time. However they thoroughly understand those companies, and invest huge amounts of research into them prior to making a significant commitment.

Positive Influence on Business Ethics

I have come to respect Buffet and Munger, not only for their demonstrated success as investors, but for teaching by example how corporate managers should treat shareholders. In fact, one of their purchase screens is to see how the managers have treated shareholders of publicly traded purchase candidates. A century ago, stock investing was a sport for the very wealthy, the very connected and anyone outside the club was fair game. $ Billions were fleeced from average people, while insiders shared secrets that allowed them to capitalize on the gullibility of the less privileged. The idea of full and fair disclosure by management to investors was as ludicrous as women's suffrage. Beginning 70 years ago (Securities and Exchange Act of 1934) this started to change, but the struggle to impose honest dealing by management continues. At last weekend's meeting, both Buffet and Munger expressed their disgust at the way in which Congress foiled an attempt by the Financial Accounting Standards Board (FASB) to force companies to expense stock options back in 1993. Failure to record this form of executive compensation as a business expense annually has masked robbery-through-dilution suffered by ordinary stock holders. It is Buffet's opinion that once corporate management realized how easily they could buy dubious accounting from Congress, their rapaciousness grew and executive compensation exploded to the obscene levels seen today. (Buffet and Munger do not accept stock options, draw low salaries, and derive benefit from a heavy ownership of Berkshire stock, aligning their interests with those of shareholders.)

I'll continue with more Insights from Omaha in the next edition of Trusted Advisor.

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(Footnotes)

1 Munger, now age 80, is a substantial minority owner of Berkshire, and is credited by Warren Buffet as his most important advisor.

2 In the early 50's Nebraska Furniture Mart challenged protected retail pricing by refusing to sell furniture at the high mark-ups then required by manufacturers.

3 The Warren Buffet CEO, Robert Miles ©2002, John Wiley & Sons

4 Simpson is widely believed to be the likely successor to Buffet in the role of investment manager, should Buffet retire or become incapacitated.