Pilgrimage to WARREN BUFFETT'S OMAHA

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PREFACE

Pilgrimage to Omaha

Each year, during the first weekend in May, Berkshire Hathaway shareholders, their friends, and their family members descend on Omaha, Nebraska for the largest financial gathering of its kind.

Seasoned professionals, amateur investors, young learners, and just plain Warren Buffett junkies, they spend the weekend renewing old friendships at Berkshire shareholder receptions and shopping for jewelry, carpeting, and high-definition televisions at special Berkshire shareholder discounts.

But mainly they come to hear Berkshire Hathaway chairman and chief executive officer Warren Buffett, the "Oracle of Omaha," answer their questions and impart his wisdom for the better part of an entire Saturday, at the company's annual meeting.

From early morning to mid-afternoon, shareholders ask—and Buffett answers—any question at all. They ask more than 50 questions, on almost any topic, from how to be a great investor to what a good first job for an ambitious 10-year-old girl would be.

Seated at a table on a small stage on the floor inside Omaha's Qwest Center arena, the chairman of one of the largest public companies in the world, along with his close friend, partner, and vice chairman, Charlie Munger, opens a dozen microphones to investors of all stripes.

No PR flack screens the questions in advance. No lawyer shields the two men from controversial questions. And no question goes unanswered, even the most deeply personal, irrelevant, or controversial. The session lasts for more than five hours, and the questioners include everyone from antiabortion protestors to Native American activists.

It is the most remarkable, yet unadorned, exhibition of good governance in corporate America.

In May 2007, 27,000 people came from around the world to attend, and for the first time in my career, I joined them.

I manage a hedge fund. Think of it as a mutual fund without borders. We can invest in anything our investors want, from stocks to bonds to currencies to oil to real estate. We can also bet *against* companies by selling short.

One other thing that distinguishes hedge funds from, say, mutual funds is the way we earn our pay. In addition to a small fee for managing the money—1 or 2 percent—we get paid a piece of the profits we generate for our investors—usually 20 percent. No profits, no pay. So we have an incentive to make money for our investors come hell or high water, bull market or bear. That's why hedge fund managers tend to be more skeptical than the average buy-and-hold investor.

Hedge funds come in all different flavors, from trading-oriented to old-fashioned investment funds, reflecting the personality of the hedge fund manager. My hedge fund is rather old-fashioned and is invested only in stocks—no fancy stuff. Like most value-oriented money managers in the business, I've studied Buffett writings, speeches, and investments for more than two decades.

Yet it wasn't until Chris Wagner, a friend in the business and a Berkshire shareholder invited me to go that I finally went to Omaha for the Berkshire annual meeting. For years, Chris had been encouraging me to attend. "It's a little spooky," he said. "It's a cult. You have to see it to really believe it."

This year, I decided to go with him, to see it for myself. And I expected to hear the old jokes, pithy maxims, and funny anecdotes that made the Berkshire meeting so popular; see his acerbic and (at least outside the Berkshire "family") underrated partner, Charlie Munger, in action, take in their company's rabidly loyal shareholders, and check out one of the most famous Berkshire Hathaway landmarks—the Nebraska Furniture Mart.

Then, like aging baby boomers who go to a Rolling Stones concert mainly to be able to say they'd seen Mick Jagger, I'd be able to say, "I saw Warren Buffett."

But as it turned out, the trip meant far more than that. Even before the plane landed in Omaha, I began to grasp that I was entering a very different world. Observations both large and small took on great meaning, from the farmlands surrounding Buffett's home town of Omaha to the remarkably low-key way in which Buffett ran the meeting in a venue the size of Madison Square Garden—glancing at his wristwatch and declaring that it was about time for the audience of 27,000 to break for lunch, for example.

Over 48 hours, I scribbled 33 pages of notes covering the profoundly engrossing question-and-answer session, a brief but enlightening conversation with two Berkshire managers, and a visit to Berkshire's fabled Nebraska Furniture Mart. The experience was an eye-opener for me, and, as I would soon find out, for the readers of my financial blog.

Now, in addition to having run a hedge fund for nearly 15 years, I also write a financial blog called JeffMatthewsIsNotMakingThisUp, reporting on whatever unusual and interesting happenings in the investment world strike my fancy.

Unusual and interesting things happen in the investment world all the time, but the most unusual—and by far the most interesting—I ever encountered was the Berkshire Hathaway annual meeting.

Returning home, I began writing about my journey to the heart of Berkshire Hathaway in what I thought might become a two- or three-part series. The response from readers, however, was overwhelming. They liked the detailed, firsthand observations about Omaha, the Berkshire shareholders, and the relationship between Buffett and Munger.

So I wrote about nearly everything I'd seen. I wrote about the way Buffett answers every question, no matter what, with a respect and an earnest manner that makes every shareholder in the building proud to say "I'm a Berkshire shareholder." And I wrote about less flattering topics that are not covered in the popular mythology, such as the absence of African American shareholders at the annual gathering of one of the most vocally progressive billionaires in history. I received feedback from novice investors and longtime Buffett admirers alike, not only from the United States but from around the world. By the time it was over, "Pilgrimage to Omaha" had become an 11-part first-person essay.

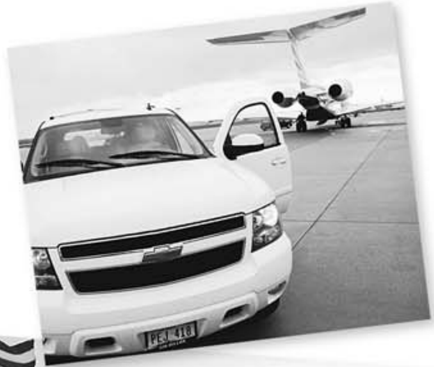
In May 2008, with Bear Stearns collapsing and the financial world in turmoil, I went back to the Berkshire Hathaway annual meeting by myself. This time, 31,000 people had come to hear the "Oracle of Omaha" and his partner take more than 60 questions from investors young and old from, quite literally, around the world. There was a new urgency in the questions.

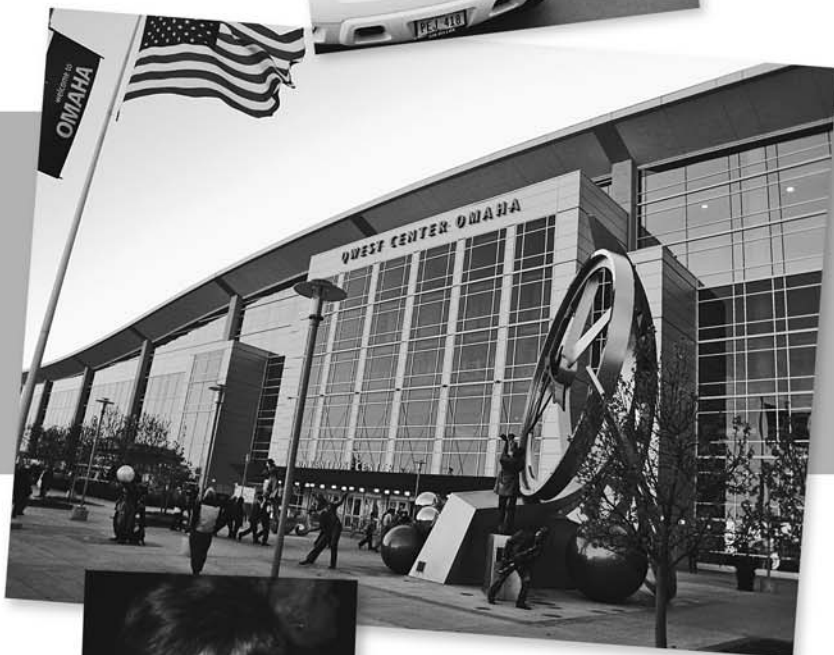
This book is an expanded version of the original essay I wrote on my blog, and describes the 2007 and 2008 Berkshire Hathaway shareholders' meetings that covered the 2006 and 2007 fiscal years. Readers will join me as I go to the midwestern city that shaped Buffett and his investment success, discover the keys to that success, and learn why not only his shareholders but the managers of the Berkshire Hathaway companies idolize the man.

I also look at questions that are not often asked: Why has Buffett owned businesses that have withered? Does Buffett's famed penny pinching cripple his companies? Did the world's most famous financial analyst miss questionable sales practices that the SEC later investigated while he sat on the board of Coke? Why won't Buffett—a bridge partner and best friend of Microsoft founder Bill Gates—buy technology stocks? How does Buffett square his well-known social progressiveness with his lily-white audience of investors?

And, most important, how will Berkshire Hathaway survive his death?

Some of the answers surprised even me.

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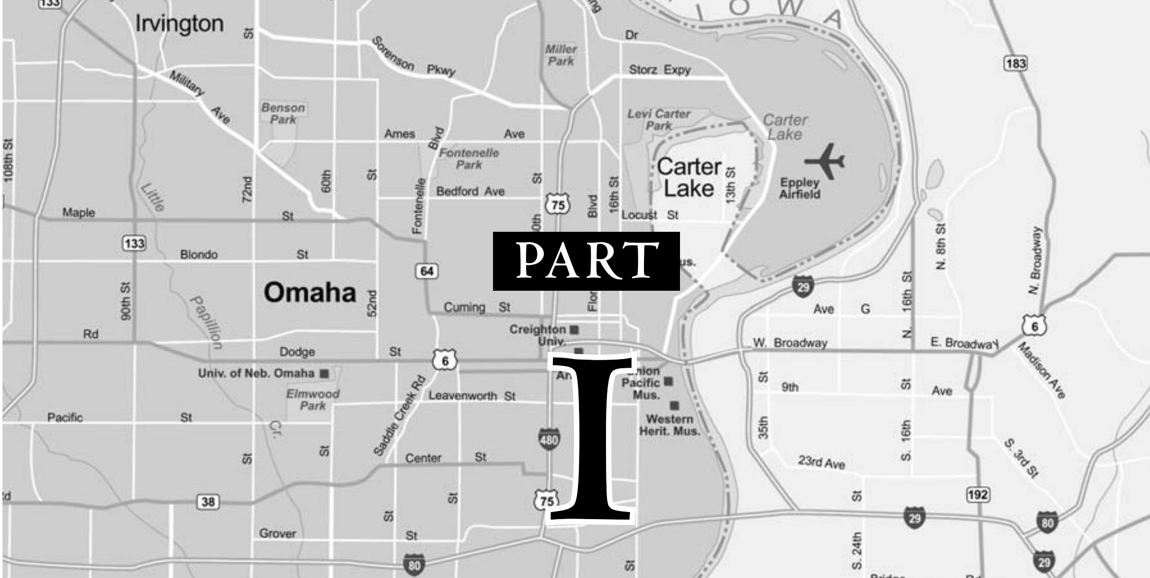

PART I

A Very Rational Place

2007

INTRODUCTION

Wired at Birth

"I was wired at birth to allocate capital."

—WARREN BUFFETT

On May 10, 1965, a self-assured young investor who was almost unknown outside his hometown of Omaha, Nebraska, arrived in New Bedford, Massachusetts. His mission: to take control of Berkshire Hathaway, a once-proud textile company that had fallen on hard times.

The *New York Times* reported the change in a low-key article in the next day's business pages:

> Textile Concern Changes Control
> BERKSHIRE HATHAWAY POLICY ROW SPURS RESIGNATIONS
>
> A policy row caused by the infusion of outside money into Berkshire Hathaway, Inc., rocked the 76-year-old textile company yesterday and resulted in the resignation of two top officers. . . .
>
> Reached last night in New York before boarding a plane to Omaha, Warren E. Buffett, 35-year-old general partner of Buffett Partnership, said that his concern had owned an interest in Berkshire Hathaway since late in 1962 and has been the largest stockholder "for some time." . . .

> Mr. Buffett said that his company was a private partnership with a few families as limited partners. As for Berkshire Hathaway, he said: "We're going to continue to sell the same goods to the same customers."

Thus began the remarkable transformation of a fading manufacturer of cotton fabrics into one of the world's biggest companies and the single best long-term stock investment in modern history, by a genial investment whiz sporting rumpled suits and thick eyeglasses, the now legendary 78-year-old chairman of Berkshire Hathaway and "Oracle of Omaha," Warren E. Buffett.

552 TIMES BETTER THAN THE DOW JONES

Far from continuing "to sell the same goods to the same customers," Buffett stopped reinvesting Berkshire's cash in textile machines and started investing it in stocks, something that he seemed uncannily good at.

In 1973, when oil prices soared and stocks crashed, Buffett bought up what is now 21.4 percent of the Washington Post Company for Berkshire at $5.63 a share. Thirty years later, those shares hit $999.50.

In 1976, he began buying up half the shares of GEICO, the direct-to-consumer auto insurer, starting at $2 a share, when Wall Street thought the company was headed for bankruptcy. Twenty years later, Berkshire acquired the other half of what was, by then, a *very* healthy company for $70 a share.

In 1988, Buffett began buying shares of Coke for Berkshire at around $5 a share, adjusted for stock splits. Wall Street thought he was crazy to pay so much for a sleepy old soft-drink company. Riding a wave of international growth, however, the company grew spectacularly over the next decade, and the stock soared to nearly $90 a share.

So it was that throughout 43 years of economic upturns and downturns, oil shocks, terrorist attacks, inflation, the Cold War, and the collapse of Communism, Warren E. Buffett—with the advice and counsel of his close partner and fellow Omaha native, Berkshire Vice Chairman Charles T. Munger—turned an old textile company into a darling of investors around the world.

But Buffett didn't just make money buying stocks; he also bought *whole companies* for Berkshire when the price and the property seemed right. In time, Berkshire no longer looked anything like the aging textile maker of 1965. By the summer of 1983 the Berkshire "family" included a local Omaha insurance company, a small California boxed-chocolate maker, a Buffalo newspaper publisher, and a furniture retailer. Later, Buffett and Munger added more insurance companies, more manufacturers, and more furniture retailers.

In fact, they bought anything that fit their idea of being a good business with good management that they could buy at a reasonable price. They acquired what is now called NetJets, the fractional jet ownership service whose customers included Tiger Woods, and they bought a brick company whose customers were plain old home buyers.

They even bought the company that makes Ginsu knives.

And while Buffett broke his promise to the *Times* that Berkshire would "continue to sell the same goods to the same customers," when, years later, he closed down Berkshire's textile operations altogether, Berkshire shareholders didn't mind a bit.

So effectively and completely did Warren Buffett and Charlie Munger transform the old Berkshire Hathaway that the price of its stock rose 842,400 percent, from $18 on the day Buffett took control to a peak of $151,650 a share in late 2007.

The Dow Jones Industrial Average, however, rose only about 1.425 percent.

What does that mean in dollars and cents? An investor who bought $10,000 worth of Berkshire Hathaway the day Warren E. Buffett took control would have owned shares worth $84 million at their peak. An investor who bought $10,000 worth of stocks in the Dow Jones Industrial Average, on the other hand, would have owned a portfolio worth about $152,500 at its peak.

The Berkshire investor did 553 times better than the Dow Jones investor.

"WE HAVE NO MASTER STRATEGY . . ."

Remarkable as that track record is, the way Warren Buffett achieved it is equally remarkable. He used no complex investment strategies; never borrowed wads of money to make big, all-or-nothing bets; and does not employ teams of financial analysts to help him find ideas.

He never even used a computer.

Instead, Buffett sat alone in an office in Omaha, Nebraska, drinking Cherry Cokes while engaged in his favorite use of time: "reading and thinking" for hours each day and talking on the phone with an ever-widening circle of business acquaintances, searching for investments.

And when he found one he liked, he acted swiftly.

His partner all along in this venture has been Charles T. Munger, a self-assured lawyer who lives and works in Los Angeles, but who was, like Buffett, born and raised in Omaha. As Buffett's sounding board on most major investment decisions, Munger is so skeptical of most proposals that Buffett affectionately calls him the "Abominable No Man."

In addition to being a reliable sounding board, however, Munger was also a key influence on Buffett's investment style. In his early years, Buffett favored investing in cheap stocks like Berkshire Hathaway, even if they were poor businesses. Munger, however, had lived, worked, and invested in the fertile postwar boom of Los Angeles, and he preferred buying only good businesses run by good managers.

Buffett, who struggled to turn Berkshire's textile business around and then simply diversified out of it, learned the hard way that, as he says, "Good jockeys will do well on good horses, but not on broken-down nags."

Together, the two men sought "good horses"—companies in a good business, with good management, but at the kind of cheap prices that Buffett loved.

Buffett explained their investment philosophy in plain language a decade ago:

> Your goal as an investor should simply be to purchase, at a rational price, a part interest in an easily-understandable business whose earnings are virtually certain to be materially higher five, ten and twenty years from now. Over time, you will find only a few companies that meet these standards—so when you see one that qualifies, you should buy a meaningful amount of stock.

Simple as that may sound, it requires a lot of work. Not physical work—there is no heavy lifting in the investment business, as Buffett likes to say—but lots of reading and thinking.

"We have no master strategy," Buffett has written. "Instead, we simply hope that something comes along—and, when it does, we act."

THE HAPPY SHOPKEEPER

Almost as remarkable as Buffett's track record and the simplicity of his investment philosophy is the fact that he does none of his work in secret, but rather opens himself up to Berkshire's investors and the public at large to such an extent that he has become the most familiar investor in the world.

Yes, Buffett accumulated shares of Washington Post and GEICO and Coke quietly, so as not to tip off copycat investors. But every time he purchased a new stock or a new business, he later wrote about it in the "Chairman's Letter" at the beginning of the company's annual report to Berkshire shareholders.

In these letters, written in clear sentences and plain language, and lightened with jokes from Woody Allen, Mark Twain, and Mae West, Buffett explained his reasoning and laid out expectations for all to see. Over time, the fame of Buffett's annual letter grew beyond Berkshire's shareholders. Soon it was being passed around among investors, analysts, and portfolio managers across Wall Street. With each annual letter, Buffett added a new chapter to what would, over time, become a lifelong course on successful investing from the world's greatest investor—himself.

Indeed, so compelling was Buffett's ability to explain himself in his letters that Berkshire shareholders began traveling to

Omaha each spring to meet the man in person at the company's annual shareholders' meeting.

For the first few years, they made their own way to the offices of the National Indemnity Company, Buffett's first insurance acquisition for Berkshire, where the meeting was held in the company cafeteria. A dozen or more investors would show up to ask "Warren and Charlie" their questions after the brief business portion of the meeting had concluded.

Attendance grew steadily thanks to word of mouth until 1985, when Buffett, who enjoyed the give and take, invited shareholders to the annual meeting in his Chairman's Letter. Two hundred fifty people showed up at Omaha's Witherspoon Hall in the Joslyn Art Museum. Informal conversation gave way to a formal question-and-answer session. Buffett and Munger would hold forth for hours with professional investors from New York and California as well as Berkshire's many loyal longtime shareholders from Omaha, including those "few families" that had been investors in Buffett Partnership, Ltd., when Buffett arrived in New Bedford to take control of Berkshire Hathaway in 1965.

The two men, equally intelligent, self-assured, and quick-witted, developed a kind of comedy routine, with Buffett's long-winded and more exuberant replies setting up dry, acerbic responses from Munger.

Buffett began concluding his annual Chairman's Letter with highlights from the previous year's shareholders' meeting and providing information about hotels, along with plugs for the Nebraska Furniture Mart, the largest home furnishings store in North America and at the time a recent addition to the Berkshire "family." He would note with pride the number of states represented by shareholders at the meeting.

Later, as Buffett's own fame grew, he began to mention the number of *countries* they represented, too.

Attendance soared along with Berkshire's stock price, soon reaching 1,000 and forcing the meeting into ever-larger venues. Berkshire began arranging buses to take shareholders to the Furniture Mart before and after the meeting. Borsheim's

Jewelers, another Berkshire acquisition, opened its doors on Sundays, against its previous policy, for shareholders who attended the meeting.

The shareholders began making an entire weekend out of it.

In 1996, 5,000 of them crowded the Holiday Convention Center for what Buffett was now calling "our capitalist version of Woodstock." Berkshire companies displayed their products and shareholders watched a low-budget movie—put together by Berkshire's chief financial officer, Mark Hamburg—that became a popular feature.

In 1998, 10,000 people filled the Aksarben Coliseum (Nebraska spelled backward). Buffett began offering employee discounts to shareholders shopping at Nebraska Furniture Mart, as well as tours of NetJets' fleet at Omaha's Eppley Airfield. GEICO specialists flew to Omaha to be on hand to help shareholders get a special discount on their car insurance.

The Berkshire annual meeting was becoming big business, for Berkshire and for Omaha. When attendance outgrew every venue in the city, Omaha opened the Qwest Center, a Madison Square Garden-sized facility with an 18,300-seat arena and an exhibition hall bigger than a Costco. Buffett and Munger could hold forth for five hours answering questions, and afterward the shareholders could buy a pair of Justin western boots, a Dairy Queen ice cream "Dilly Bar," a set of Ginsu knives, and even a Clayton *manufactured home*, all under one roof.

It was a kind of gigantic flea market for the Berkshire's family of companies, with Buffett acting as genial host, ringmaster, and happy shopkeeper.

And as the Berkshire annual meeting attracted attention from around the world, so too did Warren Buffett himself. Buffett had once bought and sold stocks in the isolation of a small room in his house on Farnam Street, but now the press began to converge on Omaha to report on what Warren and Charlie had to say. On Sunday afternoon, Buffett accommodated them with a press conference, where he would answer any and all questions.

The result of this steady, inexorable progression over the years is that Buffett's profile has grown far beyond his annual Chairman's Letter and the long question-and-answer sessions that he and Munger host at the Berkshire annual meeting the first Saturday in May.

Today, Warren Buffett is a worldwide phenomenon. Companies—mainly family-owned businesses whose owners need to raise money but don't want to lose control of their business by selling to an aggressive, hands-on corporate owner—seek out Buffett, hoping that he'll buy them.

And Buffett travels the world, spreading his message that Berkshire is the perfect buyer for those companies: "We have no corporate meetings, no corporate budgets, and no performance reviews."

His travels are covered by a CNBC anchorwoman who files gushing reports from cities across the globe; he holds press conferences upon arriving in countries, as the Beatles used to do. And for one weekend in May, shareholders travel all the way to Omaha from India, China, and South Africa to hear him speak.

"MY FAVORITE BILLIONAIRE"

But why does Warren Buffett bother?

Why does a man who once took a Dale Carnegie course in public speaking to overcome his boyhood shyness, who organized his time—somewhat at the expense of his family, it would appear—around *reading financial statements*, and who has been obsessed with his own mortality since boyhood spend his spare time talking to friends and strangers about how he invests?

First and foremost, Buffett wants what he calls "high-quality shareholders" for Berkshire, people who won't sell their stock when Buffett chooses to do something that goes against the grain of conventional wisdom. He put it this way in his 1983 Chairman's Letter:

> We feel that high quality ownership can be attracted and maintained if we consistently communicate our business and ownership

> philosophy—*along with no other conflicting messages*—and then let self selection follow its course.

And in this he has been wildly successful. As we will see, most Berkshire shareholders don't sell their stock even when Buffett himself says that things can't get better, and they might even get much worse in the short run.

Second, Buffett views his own achievements as a force largely beyond his own control. "I had nothing to do with my own success," he insists. What made him rich, Buffett will tell anybody who asks, was not daredevil risk taking or blinding foresight, it was the luck of the draw:

> I was wired at birth to allocate capital [he told Carol Loomis of *Fortune* magazine in 2006] and was lucky enough to have people around me early on—my parents and teachers and Susie [his first wife]—who helped me to make the most of that.

Because the tools for success came to him essentially for free, Buffett is merely giving back to the community at large as much as he can of those tools that made him rich.

Third, Buffett seems to genuinely enjoy the bully pulpit his fame now provides for his views, not merely on investing, but on fiscal policy and whatever strikes this self-described "political junkie" and longtime liberal Democrat as just plain wrong.

Buffett's ties to the Democratic Party go back as far as 1968, when he raised money for "Clean Gene" McCarthy's anti–Vietnam War presidential campaign. More recently, he raised funds for both Hillary Clinton and Barack Obama, and advised them on fiscal policy matters in their Democratic presidential campaigns. Hillary Clinton calls Warren Buffett "my favorite billionaire."

Many years ago, Buffett put money into a liberal-minded magazine called the *Washington Monthly* partly as a way to promote his own views on social policy, but these days he needs no printing press of his own to air his ideas. Being the world's most famous investor gives him a far bigger platform than any magazine. And he uses it, giving chatty interviews on how "the taxation system has tilted towards the rich" with Tom Brokaw and railing against "dynastic wealth" while testifying for a stiff inheritance tax before Congress.

About the only controversial area of public policy that Buffett shies away from on camera is abortion, which he actively supports.

GLOBE TROTTING AGAINST TIME

Over the years, Warren Buffett's high public profile has taken on a serious business motive far beyond that of educating his shareholders, giving something back to society, or even making his views on taxation known.

Buffett hopes to attract new acquisition candidates to Berkshire Hathaway, and as many as possible while he is still running the company. Nearing 80 years old and keenly aware of his age, Buffett knows that he must build Berkshire while he can. "We've long wanted . . . to extend Berkshire's appeal beyond U.S. borders," he wrote to shareholders in early 2007. "And last year, our globe-trotting finally got underway."

But it won't be easy.

For years, investors have been asking Buffett what will happen to Berkshire if he "gets hit by a truck." "I'd feel sorry for the truck," Buffett used to joke.

But it is no joke. To most investors and most companies around the world, Warren Buffett *is* Berkshire Hathaway.

For Warren Buffett has not just one job at Berkshire, but *two*. First, he is its chief investment officer, in charge of investing Berkshire's money, for which he is famous.

Second, he is also chief executive officer of Berkshire, in charge of managing its "family" of companies. Those companies have been purchased by Buffett personally, and most of their CEOs report directly to Warren Buffett. After all, Buffett runs a tight ship: there are only 19 people working in Berkshire's head office.

When Buffett goes, not only will Berkshire lose the most famous investor in the world, but its companies will also lose their leader.

And even though Buffett and the Berkshire board of directors have selected a successor to replace him as chief executive officer and are evaluating four candidates to repace him as chief investment officer, it is not at all clear that the Berkshire name will be enough to attract new managers and new companies without Warren Buffett behind it.

So Warren Buffett travels the globe, from Germany to India to Israel to Italy to China, so that in future years, when companies choose to sell, they will think not of "Warren Buffett," but of "Berkshire Hathaway."

It is nothing less than a race against time.