Chapter 1

Study the Best to Be the Best

"We are what we repeatedly do. Excellence is therefore not an act but a habit."

—Aristotle

Warren Buffett studies the best in every field of endeavor and from every country. He plays golf with Tiger Woods, tennis with Martina Navratilova, and bridge with two-time world champion Sharon Osberg. He'll talk bodybuilding and politics with Arnold Schwarzenegger, music with Jimmy Buffett, movie-making with Debbie Reynolds, and dance with Michael Flatley. Good friend Bill Gates discusses the latest and future world of technology. The world's best CEOs gather to seek counsel and to listen to Warren at every available opportunity. Politicians stop by Omaha for his endorsement. Presidents, legislators, judiciary members, even the chairman of the Federal Reserve greet him by first name at the annual Washington DC–based Alfalfa Club dinner every January. To be acquired by Warren's holding company is considered an honor.

In fact, not only does Warren study the best, he now has a built-in subsidiary that brings him the best of the best in the world of entertainment, athletics, entrepreneurial success, wealth, power, and corporate chiefs. Buffett's NetJets now shuttles over 5,000 high-net-worth people and the best of the best to over 140 countries in 240,000 flights each year. NetJets likes to say that anyone with a net worth of $20 million or more can do no better to enhance their lifestyle, security, safety, and comfort than to purchase an ownership interest in one of their jets. It's the equivalent of having Air Force One without being elected president of the United States.

Radio talk-show (Don Imus) and late-night television (David Letterman) hosts brag about their NetJet plane. Not just athletes, entertainers, and musicians, but even a top religious leader and spiritual advisor to U.S. presidents is attracted to this ultimate service. Even GE, the world's largest conglomerate, owns several NetJet shares to supplement their own fleet and to have the right plane and the right time for the right business meeting—all at a cost that reflects their actual use, not their ownership. As they say, buy a share and gain a fleet.

SUPERINVESTORS—PROOF THAT WARREN BUFFETT STUDIES THE BEST

Of course, Warren also studies the best at investing (which is exactly what you are doing by studying Warren Buffett). He observed, studied, lectured, and wrote that the best investors are those that follow value investment principles.

As a graduate student of economics, Warren studied security analysis under professors Ben Graham and David Dodd. In 1984, on the occasion of the fifteenth anniversary of the last published edition of *Security Analysis* written by Graham and Dodd, Warren Buffett gave a speech at his alma mater, Columbia University, titled "The Superinvestors of Graham-and-Doddsville" (see Appendix).

Warren proposed that those superinvestors (a small group that has been able to solidly beat the market over many years) have read, understood, and followed the value investing principles set forth in the book *Security Analysis* were from the virtual intellectual community of Graham and Doddsville (named by Buffett after the authors of *Security Analysis*).

He has always believed and proved it with this speech that the residents of Graham and Doddsville have achieved and continue to achieve outstanding superinvestor returns by investing in *different* stocks. Buffett asserts that average small investors can compound a portfolio better than the overall market as long as they follow the principles of Graham and Dodd, or value investing. Investors can do this by applying the same principles and methods as Buffett without actually investing in the same stocks.

Value investing, which according to Buffett describes all investing, is the art and science of buying $1 worth of assets for 50 cents. Warren not only identified and named this virtual town of Graham and Doddsville, he is one of the first residents and the rightful mayor. As you will read in Chapter 10, Lou Simpson is now deputy.

So if Buffett studies the best in every field of endeavor, not just investment management, it seems logical that if you, too, want to be an above-average investor, then you should study Warren Buffett and learn from the best.

CREATING MORE THAN $100 BILLION IN WEALTH

To understand the profound accomplishment of Warren Buffett in creating wealth, consider this: $1 million earned and invested each year for 48½ years at 10 percent annual interest equals $1 billion. Not a minor feat by anyone's standards, but Warren Buffett did this 66 times for his shareholders plus 36 times for himself or more than 100 times over his investment career of the past fifty years, and he's not finished. His partner Charlie Munger says, "Warren's getting better with age."

Billionaire Wealth:
$1 million invested each year @ 10 percent × 48½ years = $1 billion

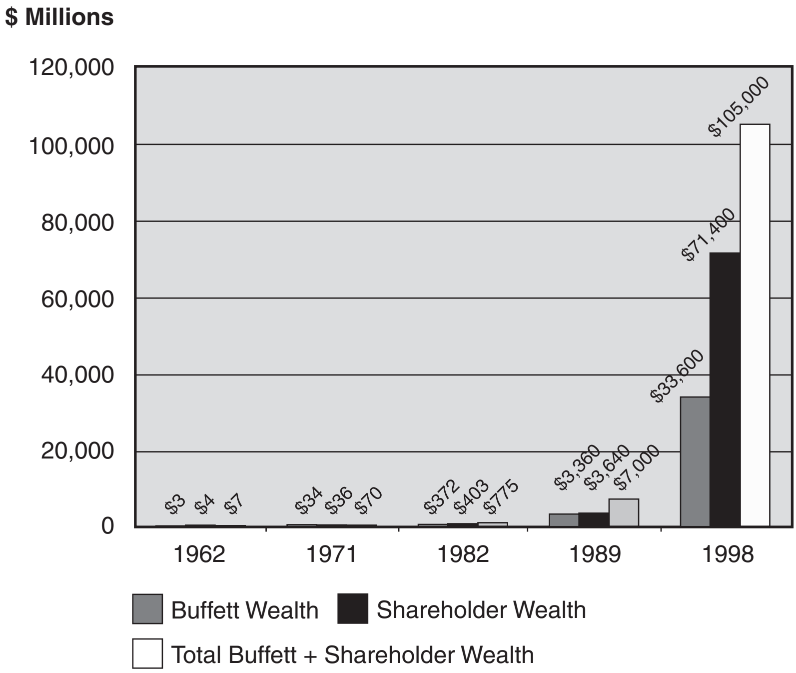
Multibillionaire Wealth:
$10 million invested each year @ 10 percent × 48½ years = $10 billion

Buffett Wealth:
$100 million invested each year @ 10 percent × 48½ years = $100 billion

Buffett treats his shareholders like partners. Buffett Wealth is created *with* shareholders, not at their expense. Figure 1.1 shows how first with a $50,000 annual salary and now with a $100,000 salary, with no additional capital investments, grew a personal $3 million investment to over $35 billion—without ever buying or selling a share of his holding company or without issuing stock options to himself.

Figure 1.1 **Buffett and Shareholder Wealth**

Source: Buffett Partnership letters and Berkshire Hathaway annual reports.



(Readers should note that aside from his salary, Warren keeps 1 percent of his net worth outside Berkshire, which is an additional $300 million. A 5 percent withdrawal of $15 million annually would be a comfortable lifestyle by almost anyone's standards.)

As Figure 1.1 and Tables 1.1 and 1.2 show, Buffett grew wealth for his partners and shareholders as he created wealth for himself, for his family, and ultimately for the benefit of the world, as his wealth will one day fund the world's largest foundation. In 1962, when Buffett had a net worth of $1.5 million, his partners had $8.5 million, for a total of Buffett and shareholder wealth of $10 million. By 1971, at the age of forty-one, Buffett had $33.6 million and his shareholders had $36.4 million for a total of $70 million. By 1982, Buffett's net worth climbed to $372 million and his partners accumulated $403 million, for a total of $775 million. Buffett achieved multibillionaire status in 1989 with $3.4 billion, his shareholders at $3.7 billion, and total wealth of $7.1 billion.

Table 1.1 **Buffett Partnership Annual Returns Compared to DJIA**

Source: Buffett Partnership letter dated January 22, 1969. Note that returns are after general partner fees of 25 percent of the gain after an annual 6 percent distribution to the partners.

Year	Buffett Partners	Dow	Value Added
1957	9.3%	(8.4%)	17.7
1958	32.2	38.5	(6.3)
1959	20.9	20.0	.9
1960	18.6	(6.2)	24.8
1961	35.9	22.4	13.5
1962	11.9	(7.6)	19.5
1963	30.5	20.6	9.9
1964	22.3	18.7	3.6
1965	36.9	14.2	22.7
1966	16.8	(15.6)	32.4
1967	28.4	19.0	9.4
1968	45.6	7.7	37.9
Total Return	1403.5	185.7	1217.8
Average Annual	25.3	9.1	16.2

Table 1.2 **How Buffett Created Wealth for Himself along with His Partners**

Source: Buffett Partnership letters.

Age	Year	Partner Wealth	Buffett Wealth
27	1957	$105,100	$100
31	1961	$7 million	$1 million
32	1962	$10 million	$1.5 million
33	1963	$18 million	$2.5 million
34	1964	$26 million	$3.5 million
35	1965	$44 million	$7 million
36	1966	$54 million	$8 million
37	1967	$68 million	$11 million
38	1968	$104 million	$25 million

In 1998, Buffett became a cultural icon and the second richest man in the world with a net worth of $33.6 billion. His partners had an additional $71.4 billion, for a total of an astonishing $105 billion. No one has ever achieved this level of wealth without *ever* selling a share of his own company's stock, issuing a management stock option, adding additional capital, cornering a new process or patent, or without ever starting and owning one's own business.

Wealth can be gained four ways: inheritance, marriage, lottery, or through the ownership of a business. All wealth, however acquired, must be preserved by ongoing ownership of a business and by underspending income generated. Buffett Wealth comes not from inheritance, marriage, lottery, or the ownership of one business, but instead through the ownership of many businesses—first in part through the stock market, and then by the outright purchase of wholly owned businesses. As you will learn, Warren Buffett has always underspent his income and has never stopped adding to his partners' and his own wealth. He is on track to accumulate over $100 billion personally, and then after his and his wife's deaths, his foundation will distribute over $5 billion per year in perpetuity.

Warren Buffett's holding company, Berkshire Hathaway, owns more businesses and a wider cross-section of industries than any other public or private conglomerate, but it has no divisions or vice presidents in charge of certain business categories. Buffett has created a very unique conglomerate.

Unlike much of the rest of the Forbes 400 list of the wealthiest individuals, Warren hasn't inherited, married into, won by lottery, or created wealth by owning a business. Warren hasn't even created any new investment methods or practices. His investment principles were learned from his mentors and early employers: his father (an Omaha-based stockbroker and U.S. congressman) and his college professor. His extraordinary investment and business success came not from any invention or method, but instead by the persistent application of old, value-based principles that are, rather amazingly, simple common sense and easy to learn and implement.

Buffett's expertise, talent, and skills are to properly value a business, access the values of management (or lack of), purchase the business at a discount to its value, and motivate and retain talented managers. He then redeploys the excess capital to replicate this feat over and over again—a virtual circle of capitalism at its finest. You too can be exceedingly wealthy if you decide to live below your income and learn and follow his methods. Actually, they aren't even his principles and practical methods, but rather the simple teachings and examples of his father and college professor.

Buffett the Multicapitalist

Most people think of a capitalist as employing capital to produce goods and services at a profit. Buffett has redefined "capitalist" into multiple dimensions.

Intellectual Capital The gift and development of extraordinary intelligence to deploy capital.

Values Capital The careful selection of ethics and principles to attract and keep capital.

Value Capital The artful acquisition of resources at a discount to their real value.

Capital Access to ever-increasing resources to allocate to their best use.

Human Capital Selecting and associating with people who cause you to perform better.

Social Capital Having the right connections for the right reasons to move in the circles that bring more and better deals.

Opportunity Capital Being the first one called when a business opportunity meeting specific acquisition criteria becomes available.

Business Model Capital Developing a business environment to attract an untold variety of businesses and managements under one umbrella.

Circle of Capital Successfully allocating the excess capital of one business into the acquisition or expansion of another.

Influence Capital Able to influence the U.S. Congress to give Salomon Brothers (a partly and previously owned company) another chance and to save the jobs of over eight thousand associates. Also able to influence all branches of government: legislative, judicial, and administrative. Can attract over fifty worldwide media outlets to cover Berkshire's annual meeting, while giving limited access to interviews during the rest of the year.

Note that you can't expect to become wealthy by investing in other people's businesses without doing a substantial amount of reading and research. In order to outperform the average investor, you must read every day and enjoy it. Unfortunately no shortcuts are available. If research isn't your cup of tea, then you may consider yourself a passive investor and might best be served by investing in a low-cost index fund, from which you will achieve the same results as the market with minimum time requirements.

STUDY THE BEST TO BE THE BEST

Why does Warren Buffett study the best in every field of endeavor? Because the traits of the best are universal and can be replicated. The best do one thing well and focus all of their life's energy doing that one thing. One of history's greatest golfers, Tiger Woods, hits five hundred golf balls everyday, just for practice. Ted Williams, considered to be the best hitter ever to play baseball, made a science of hitting and wrote a book with the same title. He carved the strike zone into seventy-seven cells, each the size of a baseball (seven balls across and eleven balls high) and marked each cell according to his ability to hit a ball in that cell. By simply hitting the balls in his self-selected zone and leaving the low-average balls alone, Williams became the best at what he did—hitting a baseball.

If Warren Buffett studies the best in every field of endeavor, why shouldn't you study him, given that he is undoubtedly the best at what he does? If you examine his investment, management, and business record, you quickly learn that no one even comes a close second.

Some aspects of investing can be very similar to gambling. Not knowing what you are doing, not understanding what you own, trading in and out of the market, following the advice of interested parties, being in a hurry to get rich, and relying on luck rather than skill are all signs of gambling. But investing and wealth building as applied by Warren Buffett is very much an art and a science and can be emulated.

Notice that Warren plays bridge in his spare time—a game of skill, not luck, and a game where choosing the right partner can make all the difference between winning and losing. The stock market, investing, and managing a business have the same characteristics. Selecting the right partners is critical. Warren's bridge partner, Sharon Osberg, is a two-time national bridge champion. She is so dedicated to bridge that it has, at many times during her career, taken the place of a full-time job. He carefully selects all of his partners and does not allow his outcome to be determined by chance and luck.

In his constant pursuit of excellence, Warren hosts one of the largest annual shareholder meetings each year in his hometown of Omaha and invites the grand masters of bridge, backgammon, Scrabble, and chess to demonstrate their skills. One master chess player (one of only fifty in the United States) takes on as many as six random chess challengers simultaneously while he is blindfolded, carefully committing each match to memory as it progresses. Patrick Wolff has rarely if ever lost a multiple blindfolded game.

Why showcase the best at games of skill? Because that is what Warren Buffett is, that is what he admires and is attracted to, and that is what is attracted to him. Genius admires genius. Talent recognizes skill. The best seek out and measure themselves against the best.

Following his passion and doing exactly what he was born to do, Warren does not believe in retirement. Jokingly, he says he will retire five years after his death. Asking him to name a replacement and retire would be like asking Picasso to stop painting. Berkshire is his masterpiece and his museum.

He has inspired and handpicked other master business artists to hang their business masterpieces at Berkshire—the Metropolitan Museum of Businesses—and to continue painting. Berkshire owns outright more than one hundred wholly owned businesses, from Dairy Queen to World Book to GEICO auto insurance. It also owns more than $30 billion in common stocks, including Coca-Cola, American Express, and Gillette. His job is simply to provide paint and brushes to the business artists or CEOs. He requests no formal meetings or budgets, offers no advice unless asked, and promises that their master business paintings will not be merged or painted over. He asks each of his business managers to act as if their business is the only asset they and their families own and as if it will not be sold for at least fifty years.

Buffett had a relationship with his first partners that guaranteed them a 6 percent annual return, after which Buffett received 25 percent of the profits.

After closing his partnership in 1969 and turning his attention to acquiring, managing, and building Berkshire into a conglomerate, Buffett has enjoyed a remarkable record, but it should be noted that making $100,000 grow to $100 million during the thirteen years of the Buffett partnership was easier than growing $17 million (Berkshire's average original acquisition cost) to over $100 billion today. The challenge of growing $100 billion to even $400 billion will be Buffett's greatest feat. If anyone can do it, he's the one. Review his extraordinary record compared to the S&P 500 and the value added over the past thirty-eight years, shown in Table 1.3.

Most professional money managers and private investors would be happy to meet and beat the S&P 500, which represents 70 percent of the publicly traded NYSE stocks. To more than double it over more than three decades is nothing short of profound. Notice, too, that he has accomplished this with only one losing year, 2001 (the S&P 500 also lost more that same year).

Warren measures himself annually and appropriately against the S&P 500 index, but he insists on calculating his benchmark by changes in book value (assets minus liabilities), which is most conservative, keeping his focus inside the business and on things he and his managers can control.

If instead he reported on annual changes in stock price (a figure determined by others outside the business and the last two people to buy and sell the stock), he would show more swings in valuations, more annual losses, and of course, a mind-blowing annual rate of return.

Tracking historical stock market prices is more volatile than tracking annual changes in book value. As Table 1.4 dramatically shows, a 30 percent average annual rate of returns from 1965 through today is worthy of analysis and study. Berkshire's CEO has written many times that he prefers book value to reflect intrinsic value (the valuation of a company based on the discounted cash flow of its owner's earnings over its useful life).

NEW-ECONOMY WAY OF INVESTING, OR TECHNOLOGY VERSUS BUFFETT

Not long ago the stock market was on an unchecked path to extraordinary increases, now known as the tech bubble or a period of irrational exuberance.

Most pundits and market participants were suggesting that because Berkshire had achieved a yearly low in March 2000, Buffett had lost his

Table 1.3 **Buffett's Performance vs. S&P 500**

Source: www.berkshirehathaway.com. Value added (Column 4) is Column 2 minus Column 3.

	Annual Percent Change		
Year	**Buffett**	**S&P 500 plus div**	**Value Added**
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	(22.1)	32.1
Overall Gain	214,433.0	3,663.0	
Average	**22.2**	**10.0**	**12.2**

***Table 1.4* Annual Changes in Berkshire's Stock Price**

Source: Barron's. August 11, 2003, Legg Mason, National Quotation Bureau, Bloomberg.

Year	Year-end Stock Price*	Berkshire	S&P 500**	Difference
1966	$17.50	(8.0)	(11.7)	3.7
1967	20.50	15.7	30.9	(15.2)
1968	37	82.7	11.0	71.7
1969	42	13.5	(8.4)	21.9
1970	39	(7.1)	3.9	(11.0)
1971	70	79.5	14.6	64.9
1972	80	14.3	18.9	(4.6)
1973	71	(11.3)	(14.8)	3.5
1974	40	(43.7)	(26.4)	(17.3)
1975	38	(5.0)	37.2	(42.2)
1976	94	147.3	23.6	123.7
1977	138	46.8	(7.4)	54.2
1978	157	13.8	6.4	7.4
1979	320	102.5	18.2	84.3
1980	425	32.8	32.3	0.5
1981	560	31.8	(5.0)	36.8
1982	775	38.4	21.4	17.0
1983	1310	69.0	22.4	46.6
1984	1275	(2.7)	6.1	(8.8)
1985	2470	93.7	31.6	62.1
1986	2820	14.2	18.6	(4.4)
1987	2950	4.6	5.1	(0.5)
1988	4700	59.3	16.6	42.7
1989	8675	84.6	31.7	52.9
1990	6675	(23.1)	(3.1)	(20.0)
1991	9050	35.6	30.5	5.1
1992	11,750	29.8	7.6	22.2
1993	16,325	38.9	10.1	28.8
1994	20,400	25.0	1.3	23.7
1995	32,100	57.4	37.6	19.8
1996	34,100	6.2	23.0	(16.8)
1997	46,000	34.9	33.4	1.5
1998	70,000	52.2	28.6	23.6
1999	56,100	(19.9)	21.0	(40.9)
2000	71,000	26.6	(9.1)	35.7
2001	75,600	6.5	(11.9)	18.4
2002	72,750	(3.8)	(22.1)	18.3
2003	†75,300	3.5	11.9	(8.4)
Average		**29.9**	**11.5**	**18.4**

*Class A shares
**Includes dividends
†Aug. 15 price

touch and was out of step with the market. But he stood to his value principles and said he didn't invest in anything he didn't understand.

In fact, he went further with his beliefs, principles, and technology investing and said if he were teaching a class on investing, he would have students perform one company valuation after another. As a final exam he would ask his students to value an Internet or dot-com company. Anyone who turned in an answer he would flunk, because the world's greatest capital allocator doesn't think it is possible to value an enterprise that is not making money, doesn't have a competitive advantage, and has an uncertain future.

Sometimes the best way to silence the critics is to stick to your guns and let time and experience play out.

Figure 1.2 illustrates that old-economy and old-school Buffett handily beat the new-economy and new-school approach as represented by the NASDAQ, which largely reflects new issues and technology companies.

THE DOWN-MARKET TEST

The true measure of a successful investor is not a comparison of performance against the NASDAQ or the Dow Jones Industrial Average (DJIA) or even the S&P 500 Index, but rather how well a portfolio performs during down markets. Table 1.5 ranks the Buffett Partnership performance by value added (the last column) and points out that during the years that the Dow was losing money, the partnership was adding the greatest value. Conversely, when the Dow was achieving 38.5 percent growth during 1958, Buffett was not able to add value.

The down-market record continues if you review Table 1.6, which ranks Berkshire's value added over the S&P 500 Index from 1965 to 2002.

Other measurements of Buffett's profound investment, management, and business success are summarized in Figures 1.3, 1.4, 1.5, and 1.6. Because Warren invests in companies with earnings that are growing over time and which are not as vulnerable to competition, these figures show rather dramatically how he has built a snowball of earnings. Berkshire buys companies with earnings, and with those earnings buys more companies. The type of industry doesn't matter; the quality of those earnings do.

As shown in Figure 1.3, in 1967 Berkshire's earnings before tax and before distributions to minority shareholders was $1.4 million. Earnings in

Figure 1.2 **Buffett (Old Economy) versus NASDAQ (New Economy)**

Source: bigcharts.com.

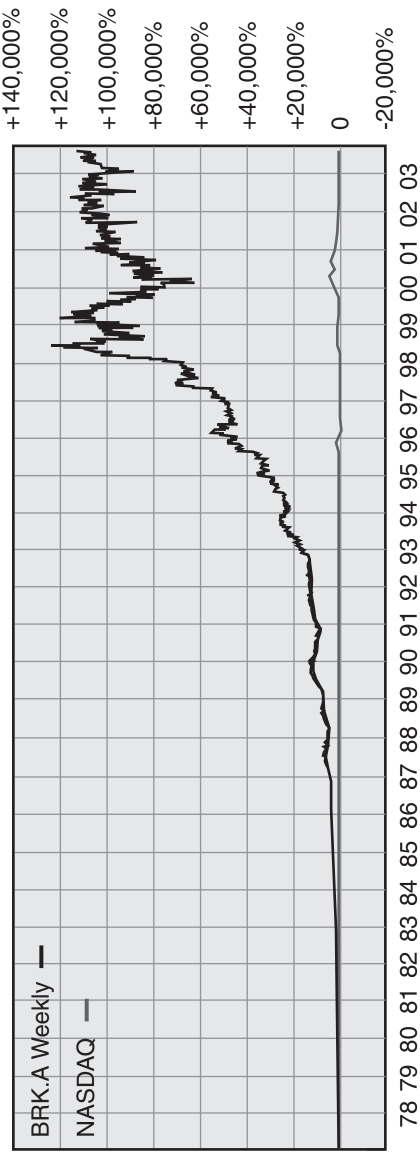


Table 1.5 **Buffett vs. DJIA, 1957–1968, Most to Least Value-Added Years**
Source: Buffett Partnership letters, 1957–1968.

Year	Buffett Partners	Dow	Value Added
1968	45.6	7.7	37.9
1966	16.8	(15.6)	32.4
1960	18.6	(6.2)	24.8
1965	36.9	14.2	22.7
1962	11.9	(7.6)	19.5
1957	9.3	(8.4)	17.7
1961	35.9	22.4	13.5
1963	30.5	20.6	9.9
1967	28.4	19.0	9.4
1964	22.3	18.7	3.6
1959	20.9	20.0	0.9
1958	32.2	38.5	(6.3)

Table 1.6 **Buffett vs. S&P 500, 1965–2002, Most to Least Value-Added Years**
Source: www.berkshirehathaway.com.

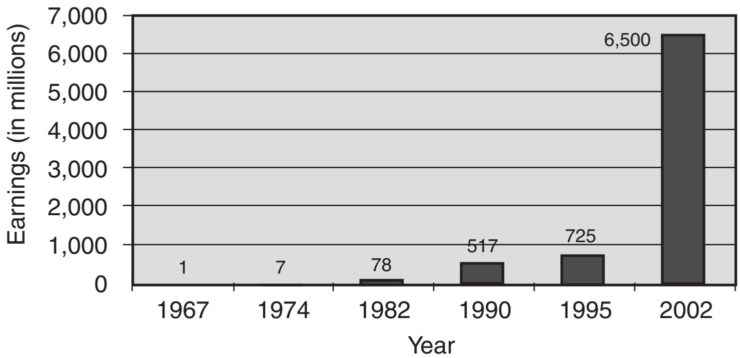
Year	Buffett	S&P 500 with Dividends	Value Added
1977	31.9	(7.4)	39.3
1981	31.4	(5.0)	36.4
1976	59.3	23.6	35.7
2002	10.0	(22.1)	32.1
1966	20.3	(11.7)	32.0
1974	5.5	(26.4)	31.9
1969	16.2	(8.4)	24.6
1998	48.3	28.6	19.7
1973	4.7	(14.8)	19.5
1982	40.0	21.4	18.6
1978	24.0	6.4	17.6
1979	35.7	18.2	17.5
1985	48.2	31.6	16.6
2000	6.5	(9.1)	15.6
1987	19.5	5.1	14.4
1965	23.8	10.0	13.8

(continued)

Table 1.6 (continued)

Year	Buffett	S&P 500 with Dividends	Value Added
1989	44.4	31.7	12.7
1992	20.3	7.6	12.7
1994	13.9	1.3	12.6
1990	7.4	(3.1)	10.5
1983	32.3	22.4	9.9
1991	39.6	30.5	9.1
1996	31.8	23.0	8.8
1970	12.0	3.9	8.1
1968	19.0	11.0	8.0
1984	13.6	6.1	7.5
1986	26.1	18.6	7.5
2001	(6.2)	(11.9)	5.7
1995	43.1	37.6	5.5
1993	14.3	10.1	4.2
1988	20.1	16.6	3.5
1972	21.7	18.9	2.8
1971	16.4	14.6	1.8
1997	34.1	33.4	0.7
1980	19.3	32.3	(13.0)
1975	21.9	37.2	(15.3)
1967	11.0	30.9	(19.9)
1999	0.5	21.0	(20.5)

Figure 1.3 **Berkshire Total Annual Earnings**
Source: Berkshire Hathaway annual reports.



1974 were $7 million. Earnings continued to grow from $78 million in 1982, to $517 million in 1990, to $725 million in 1995, and to $6.5 billion in 2002. In essence, Berkshire's capital architect has created an unlimited source of cash and a brilliant earnings business model.

Although revenue growth has never been a goal or measurement metric, it is interesting to see the dramatic growth in Berkshire's sales over time (see Figure 1.4). With Buffett's business model, sales will continue to grow because there is no restriction on the type of business or industry that Warren will add to the Berkshire Empire.

When present management took over in 1967, Berkshire Hathaway was a textile mill in New Bedford, Massachusetts, with $40 million in revenue. Through shrewd investments of its small capital base and earnings, management grew sales to $102 million in 1974, to $480 million in 1982, to $3 billion in 1991, to $4.5 billion in 1995, and to $43 billion in 2002.

Warren is unique in measuring himself annually against changes in book value (the simple calculation of assets minus liabilities), as shown in Figure 1.5. He then compares this annual percentage against the S&P 500 with dividends to determine if he has added value or not. Buffett has not only added value. He has done the remarkable, by more than doubling the returns of the S&P 500.

Figure 1.4 **Berkshire Annual Sales**
Source: Berkshire Hathaway annual reports.

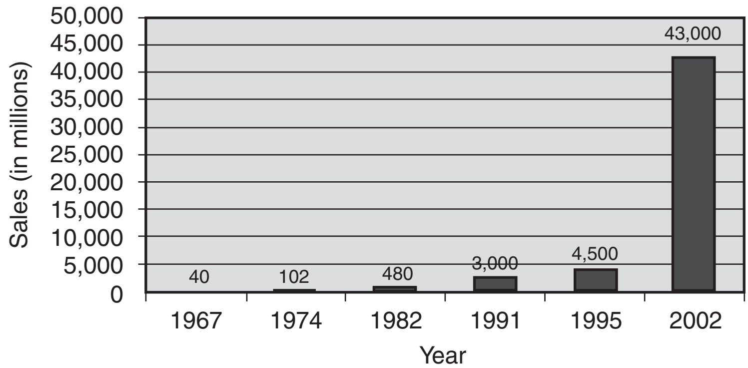
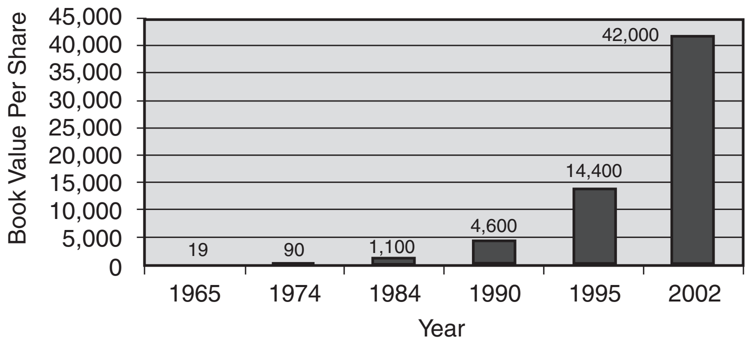


Figure 1.5 **Berkshire's Annual Book Value**
Source: Berkshire Hathaway annual reports.



Berkshire Hathaway is the largest domestic publicly traded corporation not included in the S&P 500 index. The reason is that management controls such a significant amount of stock and shareholders sell so infrequently that the stock is considered illiquid. If it is added to the S&P 500 index, which it will be one day, the price will skyrocket as mutual funds, institutions, and indexes add it to their portfolios.

Buying earnings of companies at attractive prices with outstanding management and with remarkable competitive advantages have all led to mind-boggling increases in book value.

Another metric that Warren Buffett never reports or comments on is the actual market price of his stock. He reports on the value of his business because he can control purchases, ongoing management, asset purchases and sales, liabilities, and other things that affect changes in book value. Conversely, he ignores the share price because often it has nothing to do with what is going on inside the business. Value is inside. Price is outside.

Nevertheless, changes in the share price of Berkshire stock have been nothing but extraordinary, as shown in Figure 1.6.

You may have seen a stock's prices go from single digits to double digits and sometimes to triple digits, only to be split because Wall Street likes to lower the market price to make it more psychologically appealing. Stockbrokers like splits because they are compensated by the number of shares traded. It is fascinating to study the following charts by www.bigcharts.com, shown in Figure 1.7. Berkshire has never split its stock because management wants to attract owners rather than traders.

Most large corporations issue management stock options, which offer a natural incentive for managers to manipulate earnings, issue quarterly guidance targets, and talk about their stock price. Without stock options, Berkshire has no incentive to talk up its price.

When the Buffett Partnership first started buying shares of textile maker Berkshire Hathaway, shares were purchased for $7, giving the enterprise, with 1,017,547 outstanding shares, a total valuation of a little more than $7 million. Then, given what was going on in the business, changes in book value, and Berkshire's underlying intrinsic value, the share price has steadily marched up. According to Andy Kilpatrick's book *Of Permanent Value*, the market price of Berkshire's stock has gone from $70 in 1971, to $775 in 1982, to $7,000 in 1989, and to more than $70,000 per share in 1998.

Compounding $7 to $70 is easier than growing $70,000 to $700,000. Even though the percentages are the same, the law of large numbers increases the degree of difficulty. This result once again shows the advantage of the small investor. Using the same principles and practical methods, the same portfolio outperforms the larger one every time. The Buffett Partnerships closed with approximately $100 million in 1969, achieving superior returns to the much larger Berkshire Hathaway, with a market value over

Figure 1.6 **Berkshire's Annual Share Price**
Source: Andy Kilpatrick, *Of Permanent Value* (AKPE, 2002).

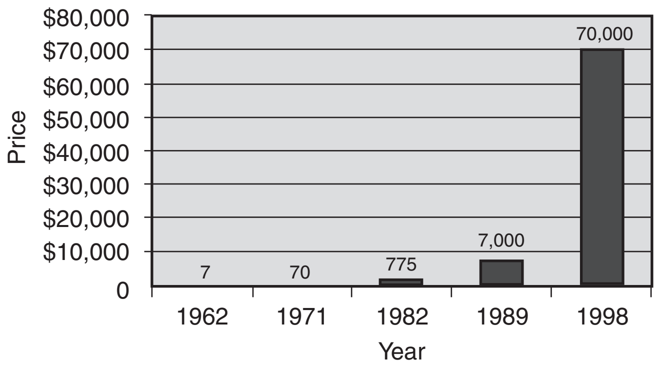
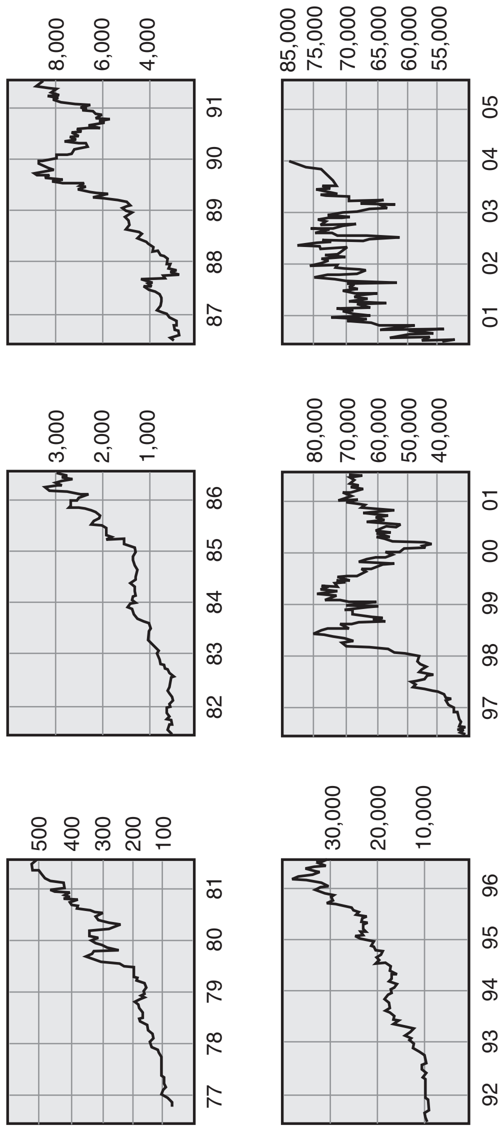


Figure 1.7 **Berkshire's Rolling Five-Year Annual Stock Price Changes, 1977–2003**

Source: bigcharts.com.



$100 billion today. Growing a small $10 million to $100 million is easier than it will be to increase $100 billion in market capitalization to $1 trillion. This is the most encouraging statistic for those investors willing to spend the time and effort to employ Buffett's methods. The small investor, equipped with the same Buffett principles and strategies, has far more investment opportunities than an investment company worth over $100 billion— even if the world's greatest capital allocator is at the helm.

CONCLUSION

To summarize, first you must study the best to become the best. Warren is the best at creating wealth by investing in other people's businesses. No one comes a close second. Warren studies the best in every field of endeavor. Wise investors study and understand Warren Buffett.

Second, wealth is created through owning a business. Wealth is also best preserved through owning a business. These concepts are the essence of capitalism. Warren has become the world's foremost capitalist by deploying earnings from various enterprises into the ownership of more businesses in order to generate more earnings to redeploy—a virtual snowball at the top of an economic mountain with enough time to create a huge, ever-expanding, and momentum-increasing capital avalanche.

Third, the best athletes become the best at focusing all of their gifts, time, and energy on becoming the best in their sport. Likewise, unless one has the benefit of inheritance or marriage, great fortunes have been created by an entrepreneur who focused all of his or her gifts, time, and energy on *one* business. Only one person has created billions in wealth by not only investing in someone else's business but many assorted businesses. His gift is one of identifying the right businesses and managers in which to invest. Others can do this—simple in theory and practice, but not easy. At a recent news conference, Buffett announced that if he were managing money in the millions instead of billions, he could compound money at an even faster rate—probably twice as fast—which has always been and will always be the average-investor advantage.

Warren Buffett hasn't invented anything new and doesn't own any patents. He has never started a business and has never taken on the day-to-day management of one. The Oracle of Omaha is so good that he doesn't even need to talk with management, access inside information, or even visit company headquarters of the businesses in which he invests. Assuming, however, that you study, understand, and employ the same Buffett principles, you too can achieve outstanding market-beating results. Knowledge counts more than experience and business contacts.

In the next chapter, we explore the timeline from a small boy growing up in Omaha, Nebraska, through his education years, and into his business life as an early hundred-aire, thousand-aire, millionaire, billionaire, and finally multibillionaire. His life is one of extraordinary wealth built on exemplary character traits.