HIGHLIGHTS FROM BUFFETT PARTNERSHIP LETTERS

Note to readers: This document was written by Mr. Frank Gifford, a Berkshire Hathaway shareholder who generously agreed to share his notes to a broader audience. The Rational Walk is pleased to make the notes available as a download for interested readers.

Copies of the full Buffett Partnership Letters are available online at the following URL:

http://www.ticonline.com/buffett.partner.letters.html

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Notes:

Most annual letters were actually written the following January. Some years also include semi-annual reports and other correspondence. For simplicity, everything here is combined under a single yearly heading.

At the beginning, Buffett compares the average performance of his partnerships against the Dow Jones Industrials plus dividends. The many partnerships were later combined and a single result is available from 1962 onward. WEB: Warren E. Buffett average of many partnerships; BPL: Buffett Partnership Ltd.

In both cases I use the "net" figure, which is what investors (limited partners) received after his "cut" (25% of profits over 6%, but nothing under 6%). His gross performance is obviously much better than the net, +45.9% versus +35.9% in 1961 for example. This is how Buffett made his first millions.

With the partnership set-up, Buffett was generally not required to report stock purchases or sales to the limited partners until he: a) wanted to do so, or b) gained controlling interest in a company.

Material that is widely quoted in the various books about Buffett is generally not repeated here, except to note its first appearance, or show a gradual shift in thinking.

Buffett was born in 1930. His first partial year running partnerships for family members was 1956. No material is available from 1956 and 1957. Perhaps these early annual reports included little more than performance updates. Words in parenthesis and starred (*) were cut-off in multi-generation photocopies, and represent an educated guess based on context.

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1958: (Dow +38.5% WEB +40.9)

...This summarizes the change in psychology dominating the stock market in 1958 at both the amateur and professional levels. During the past year, almost any reason has been seized upon to justify "investing" in the stock market. There are undoubtedly more mercurially-tempered people in the stock market now than for a good many years and the duration of their stay will be limited to how long they think profits can be made quickly and effortlessly.

I make no attempt to forecast the general market--my efforts are devoted to finding undervalued securities.

It is obvious that we could still be sitting with a $50 stock patiently buying in dribs and drabs, and I would be quite happy with such a program although our performance relative to the market last year would

have looked poor.

...Our performance for a single year has serious limitations as a basis for estimating long term results. However, I believe that a program of investing in such undervalued well protected securities offers the surest means of long term profits in securities.

(WEB is) acquiring large positions in several undervalued securities. Such a policy should lead to the fulfillment of my earlier forecast--an above average performance in a bear market or neutral market, and a normal performance in a bull market. It is on this basis that I hope to be judged.

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1959: (Dow +19.9% WEB +25.9%)

Most of you know I have been very apprehensive about general stock market levels for several years. To date, this caution has been unnecessary.

...I would rather sustain the penalties resulting from over-conservatism than face the consequences of error, perhaps with permanent capital loss, resulting from the adoption of a "New Era" philosophy where trees really do grow to the sky.

Last year I mentioned a new commitment which involved about 25% of the assets of the various partnerships. Presently, this investment is about 35% of assets.

To the extent possible, I continue to attempt to invest in situations at least partially insulated from the behavior of the general market.

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1960: (Dow -6.3% WEB +22.8%)

I would consider a year in which we declined 15% and the (Dow) Average 30% to be much superior to a year when both we and the Average advanced 20%. Over periods of time there are going to be good and bad years; there is nothing to be gained by getting enthused or depressed about the sequence in which they occur. The important thing is to be beating par....

...Our portfolio may be more conservatively, although decidedly less conventionally, invested than if we owned "blue-chip" securities.

Our bread-and-butter business is buying undervalued securities and selling when the undervaluation is corrected along with investment in "special situations" where the profit is dependent on corporate rather than market action.

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1961: (Dow +22.2% WEB +35.9%)

...One year is far too short a period to form any kind of an opinion as to investment performance....

My own thinking is much more geared to five year performance, and preferably with tests of relative results in both strong and weak markets.

Our holdings, which I always believe to be on the conservative side compared to general portfolios, tend

to (become*) more conservative as the general market level rises. At (such*) times I attempt to have a portion of our portfolio in securities at least partially insulated from the behavior of the market and this portion should increase as the market rises. However, insulation is a two-way street, so as the market boils with appetizing results for even the amateur cook (and perhaps particularly the amateur), we find that more of our portfolio is not on the stove.

We have begun open market acquisition of a potentially major commitment which I, of course, hope does nothing marketwise for at least a year. Such a commitment may be a deterrent to short range performance, but it gives strong promise of superior results over a several year period combined with substantial defensive characteristics.

My wife and I will have the largest single investment in the new partnership (after a proposed merger) probably about one-sixth of total partnership assets, and thereby a greater dollar stake in losses than any other partner or family group. I am inserting a provision in the partnership agreement which will prohibit the purchase by me or my family of any marketable securities. In other words, the new partnership will represent my entire investment (operation*) in marketable securities, so that my results will have (to*) be directly proportional to yours, subject to the advantage I obtain if we do better than 6%. (Note: Buffett got 25% of the take over 6%.)

...Many partners desire regular withdrawals and others wish to plow everything (back*)....

Estimated total assets of the (merged) partnership will be in the neighborhood of $4 million, which enables us to consider investments...which we would have had to pass several years ago.

The rub...is in being sure that we all have the same ideas of what is good and what is poor. I believe in establishing yardsticks prior to the act; retrospectively, almost anything can be made to look good in relation to something or other.

It is my feeling that three years is a very minimal test of performance....

...The Dow as an investment competitor is no pushover, and the great bulk of investment funds in the country are going to have difficulty in bettering, or perhaps even matching, its performance.

Our portfolio is very different from that of the Dow. Our method of operation is substantially different from that of mutual funds.

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(Note: Here is the first mention of Buffett's categories, something he would include and slightly modify in reports covering later years):

The first section consists of generally undervalued securities (hereinafter called "generals") where we have nothing to say about corporate policies and no timetable as to when the undervaluation may correct itself. Over the years, this has been our largest category of investment, and more money has been made here than in either of the other categories. We usually have fairly large positions (5% to 10% of our total assets) in each of five or six generals, with smaller positions in another ten or fifteen.

Sometimes these work out very fast; many times they take years. It is difficult at the time of purchase to know any specific reason why they should appreciate in price. However, because of this lack of glamour or anything pending which might create immediate favorable market action, they are available at very cheap prices. A lot of value can be obtained for the price paid. This substantial excess of value creates a comfortable margin of safety in each transaction. This individual margin of safety, coupled with a diversity of commitments creates a most attractive package of safety and appreciation potential. Over the years our timing of purchases has been considerably better than our timing of sales. We do not go

into these generals with the idea of getting the last nickel, but are usually quite content selling out at some intermediate level between our purchase price and what we regard as fair value to a private owner.

Our second category consists of "work-outs." These are securities whose financial results depend on corporate action rather than supply and demand factors created by buyers and sellers of securities....An important source in recent years has been sell-outs (of*) oil producers to major integrated oil companies.

Over the years, workouts have (provided*) our second largest category. At any given time, we may be in ten to fifteen of these....My self-imposed limit regarding borrowing (to leverage these purchases) is 25% of partnership net worth.

The final category is "control" situations where we either control the company or take a very large position and attempt to influence policies of the company. Such operations should definitely be measured on the basis of several years. (In*) a given year, they may produce nothing as it is usually to our advantage to (have*) the stock be stagnant market-wise for a long period while we are acquiring.
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I am a lot more conscious of the dangers presented at current market levels than the opportunities.

Conscious, perhaps overly conscious, of inflation, many people now feel that they are behaving in a conservative manner by buying blue chip securities (almost*) regardless of price-earnings ratios, dividend yields, etc....There is nothing at all conservative, in my opinion, about speculating to just how high a multiplier a greedy and capricious public will put on earnings.

You will not be right simply because a large number of people momentarily agree with you. You will not be right simply because important people agree with you. In many quarters the simultaneous occurrence of the two above factors is enough to make a course of action meet the test of conservatism. You will be right, over the course of many transactions, if your hypotheses are correct, your facts are correct, and your reasoning is correct. True conservatism is only possible through knowledge and reason.

Our performance in the rather mild declines of 1957 and 1960 would confirm my hypothesis that we invest in an extremely conservative manner.

I am certainly not going to predict what general business or the stock market are going to do in the next year or two since I don't have the faintest idea.

I think you can be quite sure that over the next ten years there are going to be a few years when the general market is plus 20% or 25%, a few when it is minus on the same order, and a majority when it is in between. I haven't any notion as to the sequence in which these will occur, nor do I think it is of any great importance for the long-term investor.

Despite the experience of recent years, anyone expecting substantially better than that from the general market probably faces disappointment.

There are bound to be years when we are surpassed by the Dow, but if over a long period we can average ten percentage points per year better than it, I will feel the results have been satisfactory.

In one year, the variations may be quite substantial. This happened in 1961, but fortunately the variation was on the pleasant side. They won't all be!

We are now installed in an office at 810 Kiewit Plaza....My father is sharing office space with us (he also shares the expenses)....Over-all, I expect our overhead, excluding interest on borrowings and Nebraska

Intangibles Tax, to run less than .5 of 1% of net assets. We should get our money's worth from this expenditure, and you are most cordially invited to drop in and see how the money is being spent.

(We have) over 90 partners and probably 40 or so securities...We presently have partners residing in locations from California to Vermont....Susie and I have an interest in the partnership amounting to $1,025,000.00....

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1962: (Dow -7.6% BPL +11.9%)

Our target is an approximately 1/2% decline for each 1% decline in (the Dow*) and if achieved, means we have a considerably more conservative (vehicle*) for investment in stocks than practically any alternative.

During the first half of 1962 we had one of the best periods in our history, achieving a minus 7.5% result before payments to partners, compared to the minus 21.7% over-all result on the Dow.

...Six-months' or even one-year's results are not to be taken too seriously. Short periods of measurement exaggerate chance fluctuations in performance.

...Earlier superior performance had caused such a rush of new investors to come to (growth mutual funds) that the poor performance this year (Note: much worse than the Dow) was experienced by very many more holders than enjoyed the excellent performance of earlier years.

Our attorneys have advised us to admit no more than a dozen new partners (several of whom have already expressed their desire) and accordingly, we have increased the minimum amount for new names to $100,000.

Whether we do a good job or a poor job is not to be measured by whether we are plus or minus for the year. It is instead to be measured against the general experience in securities as measured by the Dow-Jones Industrial Average, leading investment companies etc.

While I much prefer a five-year test, I feel three years is an absolute minimum for judging performance....If any three-year or longer period produces poor results, we all should start looking around for other places to have our money. An exception to the latter statement would be three years covering a speculative explosion in a bull market.

I am not in the business of predicting general stock market or business fluctuations. If you think I can do this, or think it is essential to an investment program, you should not be in the partnership.

I cannot promise results to partners. What I can and do promise is that:
a) Our investments will be chosen on the basis of value, not popularity.
b) That we will attempt to bring risk of permanent capital loss (not short-term quotational loss) to an absolute minimum by obtaining a wide margin of safety in each commitment and a diversity of commitments; and
c) My wife, children and I will have virtually our entire net worth invested in the partnership.

(Following a cumulative performance chart showing the net results from 1957 onward beating the Dow by an annual compound rate of 21.1%): My (unscientific) opinion is that a margin of ten percentage points per annum over the Dow is the very maximum that can be achieved with invested funds over any long period of years, so it may be well to mentally modify some (of*) the above figures. (Note how this theme will be repeated and honed in future years.)

At the beginning of 1957, combined limited partnership assets totaled $303,726 and grew to $7,178,500 at the beginning of 1962.

...The Dow is no pushover as an index of investment achievement. The advisory talent managing just (four widely-held mutual funds of the day) commands annual fees of approximately $7 million, and this represents a very small fraction of the industry. Nevertheless, the public batting average of this highly-paid talent indicates results slightly less favorable than the Dow.

The actual percentage division among categories (see 1961) is to some degree planned, but to a great extent, accidental, based upon availability factors.

We usually have fairly large positions (5% to 10% of our total assets) in each of five or six generals, with smaller positions in another ten or fifteen.

Sometimes these work out very fast; many times they take years. It is difficult at the time of purchase to know any compelling reason why they should appreciate in price. However, because of this lack of glamour or anything pending which might create immediate favorable market action, they are available at very cheap prices.

Over the years, work-outs have provided our second largest category. At any given time, we may be in five to ten of these; some just beginning and others in the late stage of their development. I believe in using borrowed money to offset a portion of our work-out portfolio, since there is a high degree of safety in this category in terms of both eventual results and intermediate market behavior....My self-imposed standard limit regarding borrowing is 25% of partnership net worth, although something extraordinary could result in modifying this for a limited period of time.

(About gaining control of faltering Dempster Mill Manufacturing, a Nebraska farm supply company, and bringing in a new manager):
To some extent, we have converted the assets from the manufacturing business which has been a poor business, to a business which we think is a good business--securities. By buying assets at a bargain price, we don't need to pull any rabbits out of a hat to get extremely good percentage gains. This is the cornerstone of our investment philosophy: "Never count on making a good sale. Have the purchase price be so attractive that even a mediocre sale gives good results. The better sales will be the frosting on the cake."

It should be pointed out that Dempster last year was 100% an asset conversion problem and therefore, completely unaffected by the stock market and tremendously affected by our success with the assets.

...More conventional (often termed conservative which is not synonymous) methods of common stock investing.

If the next four years are going to involve, say, a +40%, -30%, +10% and -6%, the order in which they fall is completely unimportant for our purposes as long as we all are around at the end of four years.

...If the Dow produces a 5% per year over-all gain compounded, I would hope our results might be 15% per year. The above expectations may sound somewhat rash, and there is no question but they might appear very much so when viewed from the vantage point of 1965 or 1970. Variations in any given year from the behavior described above would be wide, even if the long-term expectation was correct. Certainly, you have to recognize the possibility of substantial personal bias in such hopes.

This year marked the transition from the office off the bedroom to one a bit (quite a bit) more conventional. Surprising as it may seem, the return to a time clock life has not been unpleasant. As a matter of fact, I enjoy not keeping track of everything on the backs of envelopes.

...We have added to our partnership interest so that we now have an interest of $1,377,400.00. Also, my three children, mother, father, two sisters, two brothers-in-law, father-in-law, three aunts, four cousins, five nieces and nephews have interests directly or indirectly totaling $893,600.00.

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1963: (Dow +20.7% BPL +30.5%)

We consider all three of our categories to be good businesses on a long-term basis, although their short-term price behavior characteristics differ substantially in various types of markets. We consider attempting to gauge stock market fluctuations to be a very poor business on a long-term basis and are not going to be in it, either directly or indirectly through the process of trying to guess which of our categories is likely to do best in the near future.

The results continue to show that the most highly paid and respected investment advice has difficulty matching the performance of an unmanaged index of blue-chip stocks. This in no sense condemns these institutions or the investment advisers and trust departments whose methods, reasoning, and results largely parallel such investment companies. These media perform a substantial service to millions of investors in achieving adequate diversification, providing convenience and peace of mind, avoiding issues of inferior quality, etc. However, their services do not include (and in the great majority of cases are not represented to include) the compounding of money at a rate greater than that achieved by the general market.

Our partnership's fundamental reason for existence is to compound funds at a better-than-average rate with less exposure to long-term loss of capital than the above investment media. We certainly cannot represent that we will achieve this goal. We can and do say that if we don't achieve this goal over any reasonable period, excluding an extensive speculative boom, we will cease operation.

(Under new management which Buffett installed): Dempster earned a very satisfactory operating profit in the first half (as well as a substantial unrealized gain in securities) and there is little question that the operating business, as now conducted, has at least moderate earning power on the vastly reduced assets needed to conduct it.

...I must confess that I find a bit more substance in this fingers and toes method than in any prayerful reliance that someone will pay me 35 times next year's earnings.

A tremendous number of fuzzy, confused investment decisions are rationalized through so-called "tax considerations."

Investment decisions should be made on the basis of the most probable compounding of after-tax net worth with minimum risk.

While we always had a built-in profit in Dempster because of our bargain purchase price, Harry (Bottle) accounted for several extra servings of dessert by his extraordinary (restructuring) job.

(First appearance in a long list of similar boilerplate disclaimers over the years): You should be aware that if our final results relative to the Dow for 1963 are as favorable as on October 31st, I will regard it as an abnormal year. I do not consider a 13.2 percentage point margin to be in the cards on a long term basis. A considerably more moderate annual edge over the Dow will be quite satisfactory. (Written: November 6, 1963)

...In my judgment our 17.7 margin over the Dow (comparing gross compounded results 1957-63) is

unattainable over any long period of time. A ten percentage point advantage would be a very satisfactory accomplishment.... (Note that "net" compounded results for the limited partners were 22.3% annually to date--not far from Buffett's long-term record four-decades later.)

The Dow, of course, is an unmanaged index, and it may seem strange to the reader to contemplate the high priests of Wall Street striving vainly to surpass or even equal it. However, this is demonstrably the case. Moreover, such a failure cannot be rationalized by the assumption that the investment companies et al are handling themselves in a more conservative manner than the Dow....The behavior of common stock portfolios managed by this group, on average, have declined in concert with the Dow. By such a test of behavior in declining markets, our own methods of operation have proven to be considerably more conservative than the common stock component of the investment company or investment advisor group.

Within their institutional framework and handling the many billions of dollars involved, the results achieved are the only ones attainable. To behave unconventionally within this framework is extremely difficult. Therefore, the collective record of such investment media is necessarily tied to the record of corporate America.

My opinion is that the Dow is quite unlikely to compound for any important length of time at the rate it has during the past seven years (10%) and...I believe our margin over the Dow cannot be maintained at its level to date (Net: 22.3%).

Our three investment categories are not differentiated by their expected profitability over an extended period of time,. We are hopeful that they will each, over a ten or fifteen year period, produce something like the ten percentage point margin over the Dow that is our goal.

(Note the new standards here compared with 1961):
"Generals"--A category of generally undervalued stocks, determined primarily by quantitative standards, but with considerable attention also paid to the qualitative factor. There is often little or nothing to indicate immediate market improvement. The issues lack glamour or market sponsorship. Their main qualification is a bargain price; that is, an overall valuation on the enterprise substantially below what careful analysis indicates its value to a private owner to be. Again let me emphasize that while the quantitative comes first and is essential, the qualitative is important. We like good management--we like a decent industry--we like a certain amount of "ferment" in a previously dormant management or stockholder group. But we demand value.

"Workouts"--We wait until we can read it in the paper.

"Controls"--Unless we start off with the purchase of a sizable block of stock, controls develop from the general category....The general we have been buying the most aggressively in recent months possesses excellent management following policies that appear to make very good sense to us. If our continued buying puts us in a controlling position at some point in the future, we will probably remain very passive regarding the operation of this business.

We do not want to get active merely for the sake of being active. Everything else being equal I would much rather let others do the work.

The sine qua non of this operation is an attractive purchase price.

Our willingness and financial ability to assume a controlling position gives us two-way stretch on many purchases in our group of generals. If the market changes its opinion for the better, the security will advance in price. If it doesn't we will continue to acquire stock until we can look to the business itself rather than the market for vindication of our judgment.

For this reason, in controls, we are looking for wide margins of profit--if it looks at all close, we pass.

Our idea inventory has always seemed to be 10% ahead of our bank account.

Early in 1962 I heard rumors regarding a sellout to Union Oil of California. I never act on such information, but in this case it was correct and substantially more money would have been made if we had gone in at the rumor stage rather than at the announced stage. However, that's somebody else's business, not mine.

(This is) typical of our bread-and-butter type of operation. We attempt to obtain all facts possible, continue to keep abreast of developments and evaluate all of this in terms of our experience. We certainly don't go into all the deals that come along--there is considerable variation in their attractiveness.

(Dempster): This situation started as a general in 1956, At that time the stock was selling at $18 with about $72 in book value of which $50 per share was in current assets (cash, receivables and inventory) less all liabilities. Dempster had earned good money in the past, but was only breaking even currently. The qualitative situation was on the negative side (a fairly tough industry and unimpressive management), but the figures were extremely attractive....We continued to buy the stock in small quantities for five years....(Eventually Buffett gained control and imposed new management): This, coupled with the gain we have in our portfolio of marketable securities, gives us a realization of about $80 per share.

Our business is making excellent purchases--not making extraordinary sales.

The Dempster saga points up several morals:
(1) Our business is one requiring patience. It has little in common with a portfolio of high-flying glamour stocks and during periods of popularity for the latter, we may appear quite stodgy.
It is to our advantage to have securities do nothing price-wise for months, or perhaps years, while we are buying them. This points up the need to measure our results over an adequate period of time. We suggest three years as a minimum.
(2) We cannot talk about our current investment operations. Such an "open-mouth" policy could never improve our results and in some situations could seriously hurt us. For this reason, should anyone, including partners, ask us whether we are interested in any security, we must plead the "5th Amendment."

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1964: (Dow +18.7% BPL +22.3%)

Our General category now includes three companies where BPL (Buffett Partnership Limited) is the largest single stockholder. These stocks have been bought and are continuing to be bought at prices considerably below their value to a private owner. We have been buying one of these situations for approximately eighteen months and both of the others for about a year. It would not surprise me if we continue to do nothing but patiently buy these securities week after week for at least another year, and perhaps even two years or more.

What we really like to see in situations like the three mentioned above is a condition where the company is making substantial progress in terms of improving earnings, increasing asset values, etc., but where the market price of the stock is doing very little while we continue to acquire it....Such activity should usually result in either appreciation of market prices from external factors or the acquisition by us of a controlling position in a business at a bargain price. Either alternative suits me.

It is important to realize, however, that most of our holdings in the General category continue to be

securities which we believe to be considerably undervalued, but where there is not the slightest possibility that we could have a controlling position.

We feel it is essential that investors and investment managements establish standards of performance and, regularly and objectively, study their own results just as carefully as they study their investments.

We do not play any games to either accelerate or defer taxes. We make investment decisions based on our evaluation of the most profitable combination of probabilities. If this means paying taxes--fine--I'm glad the rates on long-term capital gains are as low as they are.

(About investment firms which claim to have centuries of aggregate experience): (This) brings to mind the fellow who (applied*) for a job and stated he had twenty years of experience--which was (corrected*) by the former employer to read "one year's experience--twenty times."

...My perhaps jaundiced view is that it is close to impossible for outstanding investment management to come from a group of any size with all parties really participating in decisions; (2) a desire to confirm to the policies and (to an extent) the portfolios of other large well-regarded organizations; (3) an institutional framework whereby average is "safe" and the personal rewards for independent action are in no way commensurate with the general risk attached to such action; (4) an adherence to certain diversification practices which are irrational; and finally and importantly, (5) inertia. (Note: This is an early formulation of the famous "lemmings" quote.)

Both our portfolio and method of operation differ substantially from the investment companies (shown) in a table (of comparative results).

I have over 90% of my net worth in BPL, and most of my family have percentages in that area....

It is unquestionably true that the investment companies have their money more conventionally invested than we do. To many people conventionality is indistinguishable from conservatism. In my view, this represents erroneous thinking. Neither a conventional nor an unconventional approach, per se, is conservative.

Truly conservative actions arise from intelligent hypotheses, correct facts, and sound reasoning. These qualities may lead to conventional acts, but there have been many times when they have led to unorthodoxy. In some corner of the world they are probably still holding regular meetings of the Flat Earth Society.

We derive no comfort because important people, vocal people, or great numbers of people agree with us. Nor do we derive comfort if they don't. A public opinion poll is no substitute for thought. When we really sit back with a smile on our face is when we run into a situation we can understand, where the facts are ascertainable and clear, and the course of action obvious. In that case--whether conventional or unconventional--whether others agree or disagree--we feel we are progressing in a conservative manner.

Over a span of 20 or 30 years, I would expect something more like 6%-7% overall annual gain from the Dow instead of the 11.1% during our brief history.

We do not consider it possible on an extended basis to maintain the 16.6 percentage point advantage over the Dow of the Partnership or the 11.2 percentage point edge enjoyed by the limited partners. We have had eight consecutive years in which our pool of money has out-performed the Dow, although the profit allocation arrangement left the limited partners short of Dow results in one of those years.

...My own investment philosophy has developed around the theory that prophecy reveals far more of the frailties of the prophet than it reveals of the future.

...You, as partners, are entitled to know my expectations...I am hopeful that our longer term experience will unfold along the following basis:
(1) An average gain from the Dow (including dividends, of course) averaging in the area of 7% per annum, exhibiting customarily wide amplitudes in achieving this average--say, on the order of minus 40% to plus 50% at the extremes with the majority of years in the minus 10% to plus 20% range.
(2) An average advantage of ten percentage points per annum for BPL before allocation to the general partner--again with large amplitudes in the margin....
(3) The product of these two assumptions gives an average of 17% to BPL or about 14% to limited partners.

In the great majority of (potential stock market investments) we simply do not know enough about the industry or company to come to sensible judgments--in that situation we pass.

An investment operation that depends on the ultimate buyer making a bum deal (in Wall Street they call this the "Bigger Fool Theory") is tenuous indeed. How much more satisfactory it is to buy at really bargain prices so that only an average disposition brings pleasant results.

What is one really trying to do in the investment world? Not paying the least taxes, although that may be a factor to be considered in achieving the end. Means and end should not be confused, however, and the end is to come away with the largest after-tax rate of compound.

It is extremely improbable that 20 stocks selected from, say, 3000 choices are going to prove to be the optimum portfolio both now and a year from now at the entirely different prices (both for the selections and the alternatives) prevailing at that later date. If our objective is to produce the maximum after-tax compound rate, we simply have to own the most attractive securities obtainable at current prices. And, with 3,000 rather rapidly shifting variables, this must mean change (hopefully "tax-generating" change).

It is obvious that the performance of a stock last year or last month is no reason, per se, to either own it or to not own it now. It is obvious that an inability to "get even" in a security that has declined is of no importance. It is obvious that the inner warm glow that results from having held a winner last year is of no importance in making a decision as to whether it belongs in an optimum portfolio this year.

(About tax rates being lower on capital gains than on earned income): ...tax policy indicates digging ditches is regarded as socially less desirable than shuffling stock certificates.

...It is going to continue to be the policy of BPL to try to maximize investment gains, not minimize taxes. We will do our level best to create the maximum revenue for the Treasury--at the lowest rates the rules will allow.

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1965: (Dow +14.2% BPL +36.9%)

Although we deal with probabilities and expectations, the actual results can deviate substantially from such expectations, particularly on a short-term basis.

When...a controlling interest is acquired, the assets and earning power of the business become the immediate predominant factors in value....When a controlling interest is held, we own a business rather than a stock and a business valuation is appropriate.

...The beauty of the American economic scene has been that random results have been pretty darned good results.

...We expect on a long-term basis to earn better than 6% (the general partner's allocation is zero unless we do) although it is largely a matter of chance whether we achieve the 6% figure in any short period.

(Update dated November 1, 1965): The partnership owns a controlling interest in Berkshire Hathaway, Inc., a publicly-traded security.

(Refers to expectations for the Dow and BPL quoted under 1964): My fallibility as a forecaster was quickly demonstrated when the first year fell outside my parameters. We achieved our widest margin over the Dow in the history of BPL with an overall gain of 47.2% compared to an overall gain (including dividends which would have been received through ownership of the Dow) of 14.2% for the Dow. Naturally, no writer likes to be publicly humiliated by such a mistake. It is unlikely to be repeated.

A disadvantage of this (investment management) business is that it does not possess momentum to any significant degree.

...In the lyrical words of Casey Stengel, "Show me a good loser, and I'll show you a loser."

...Several investments that were just the right size for us--big enough to be significant and small enough to handle.

I now feel that we are much closer to the point where increased size may prove disadvantageous. (Note: Assets were over $43 million then.)

Therefore, unless it appears that circumstances have changed (under some conditions added capital would improve results) or unless new partners can bring to some asset to the Partnership other than simply capital, I intend to admit no additional partners to BPL.

...I visualize the curve of expectable performance sloping only very mildly as capital increases....

A private owner was quite willing (and in our opinion quite wise) to pay a price for control of the business which isolated stock buyers were not willing to pay for very small fractions of the business.

Our purchases of Berkshire started at a price of $7.60 per share in 1962.

In the postwar period the company had slid downhill a considerable distance, having hit a peak in 1948 when about $29 1/2 million was earned before tax and about 11,000 workers were employed. This reflected output from 11 mills. At the time we acquired control in spring of 1965, Berkshire was down to two mills and about 2,300 employees.

Berkshire is a delight to own....While a Berkshire is hardly going to be as profitable as a Xerox, Fairchild Camera or National Video in a hyper tensed market, it is a very comfortable sort of thing to own.

I do not have a great flood of good ideas as I go into 1966, although again I believe I have at least several potentially good ideas of substantial size. Much depends on whether market conditions are favorable for obtaining a larger position.

This year in the material which went out in November, I specifically called your attention to a new Ground Rule reading, "7. We diversity substantially less than most investment operations. We might invest up to 40% of our net worth in a single security under conditions coupling an extremely high probability that our facts and reasoning are correct with a very low probability that anything could drastically change the underlying value of the investment."

We have to work extremely hard to find just a few attractive investment situations.

...Our business is that of ascertaining facts and then applying experience and reason to such facts to reach expectations. Imprecise and emotionally influenced as our attempts may be, that is what the business is all about....I believe the investor operates at a distinct advantage when he is aware of what path his though process is following.

There is one thing of which I can assure you. If good performance of the fund is even a minor objective, any portfolio encompassing one hundred stocks (whether the manager is handling one thousand dollars or one billion dollars) is not being operated logically.

Anyone owning such numbers of securities after presumably studying their investment merit (and I don't care how prestigious their labels) is following what I call the Noah School of Investing--two of everything. Such investors should be piloting arks.

...I am willing to concentrate quite heavily in what I believe to be the best investment opportunities recognizing very well that this may cause an occasional very sour year--one somewhat more sour, probably, than if I had diversified more. While this means our results will bounce around more, I think it also means that our long-term margin of superiority should be greater.

You have already seen some examples of this. Our margin versus the Dow has ranged from 2.4 percentage points in 1958 to 33.0 points in 1965....Looking back, and continuing to think this problem through, I feel that if anything, I should have concentrated slightly more than I have in the past. Hence, the new Ground Rule and this long-winded explanation.

We probably have had only five or six situations in the nine-year history of the Partnership where we have exceed 25% (allocation to a single stock).

(With a well-selected concentrated portfolio)...the chance of serious permanent loss is minimal (anything can happen on a short-term quotational basis)....

We presently have two situations in the over 25% category....

It is worth pointing out that our performance in 1965 was overwhelmingly the product of five investment situations.

...For our summation on over diversification, we turn to that eminent academician Billy Rose, who says, "You've got a harem of seventy girls; you don't get to know any of them very well."

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1966: (Dow -15.6% BPL +16.8%)

(About diversification among high-quality stocks in many mutual funds of the period): Since, over a long term, "average experience" is likely to be good experience, there is nothing wrong with the typical investor utilizing this form of investment medium.

I still prefer the iceberg approach toward investment disclosure.

All of our investments usually appear undervalued to me--otherwise we wouldn't own them.

We don't buy and sell stocks based upon what other people think the stock market is going to do (I never have an opinion) but rather upon what we think the company is going to do.

Our investments are simply not aware that it takes 365 1/4 days for the earth to make it around the sun.

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(From the July 12 semi-annual update):

I resurrect this "market-guessing" section only because after the Dow declined from 995 at the peak in February to about 865 in May, I received a few calls from partners suggesting that they thought stocks were going a lot lower. This always raises two questions in my mind: (1) if they knew in February that the Dow was going to 865 in May, why didn't they let me in on it then; and (2) if they didn't know what was going to happen during the ensuing three months back in February, how do they know in May? There is also a voice or two after any hundred point or so decline suggesting we sell and wait until the future is clearer. Let me again suggest two points: (1) the future has never been clear to me (give us a call when the next few months are obvious to you--or, for that matter, the next few hours); and, (2) no one ever seems to call after the market has gone up one hundred points to focus my attention on how unclear everything is, even though the view back in February doesn't look so clear in retrospect.

If we start deciding, based on guesses or emotions, whether we will or won't participate in a business where we should have some long-run edge, we're in trouble. We will not sell our interests in businesses (stocks) when they are attractively priced just because some astrologer thinks the quotations may go lower even though such forecasts are obviously going to be right some of the time. Similarly, we will not buy fully priced securities because "experts" think prices are going higher. Who would think of buying or selling a private business because of someone's guess on the stock market? The availability of a quotation for your business interest (stock) should always be an asset to be utilized if desired. If it gets silly enough in either direction, you take advantage of it. Its availability should never be turned into a liability whereby its periodic aberrations in turn formulate your judgments. A marvelous articulation of this idea is contained in chapter two (The Investor and Stock Market Fluctuations) of Benjamin Graham's "The Intelligent Investor". In my opinion, this chapter has more investment importance than anything else that has been written.
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...The door has been shut regarding new entrants (unless they have something to contribute to the partnership other than simply capital)....

Controlling interests (in a company) frequently sell at from 60% to 500% of virtually contemporaneous prices for minority holdings.

The dominant factors affecting control valuations are earning power (present*) and prospective and asset values.

...An all-time record (both past and future) was established for our performance margin relative to the Dow. Our advantage was 36 points which resulted from a plus 20.4% for the Partnership and a minus 15.6% for the Dow.

Annual Compounded Rate (10 year anniversary): Dow: +8.3%
Partnership Results (including predecessors, gross): +28.8%
Limited Partners' Results (net after Buffett's take): +23.2%

...Investment companies diversify far more than we do and, in all probability, thereby have less chance for a really bad performance relative of the Dow in a single year; and (3) their managers have considerably less incentive for abnormal performance and greater incentive for conventionality.

A few mutual funds and some private investment operations have compiled records vastly superior to the

Dow and, in some cases, substantially superior to Buffett Partnership, Ltd. Their investment techniques are usually very dissimilar to ours and not within my capabilities.

(Note: Buffett was 25 and started operations with capital of $105,100 in 1956): The results of the first ten years have absolutely no chance of being duplicated or even remotely approximated during the next decade. They may well be achieved by some hungry twenty-five year old working with $105,100 initial partnership capital and operating during a ten year business and market environment which is frequently conducive to successful implementation of his investment philosophy. (Note: Berkshire's book-value would increase 21.4% annually 1965-2006.)

They will not be achieved by a better fed thirty-six year old working with our $54,065,345 current partnership capital who presently finds perhaps one-fifth to one-tenth as many really good ideas as previously to implement his investment philosophy.

I tried to find some brilliant flash of insight regarding our future or present conditions from my first page and a half annual letter of January, 1957 to insert as a quote here. However, someone evidently doctored my file copy so as to remove the perceptive remarks I must have made.

At that time, and for some years subsequently, there were substantial numbers of securities selling at well below the "value to a private owner" criterion we utilized for selection of general market investments.

In the last few years this situation has changed dramatically. We now find very few securities that are understandable to me, available in decent size, and which offer the expectation of investment performance meeting our yardstick of ten percentage points per annum superior to the Dow. In the last three years we have come up with only two or three new ideas a year that have had such an expectancy of superior performance.

(First appearance of this theme): We will not go into businesses where technology which is away over my head is crucial to the investment decision. I know about as much about semi-conductors or integrated circuits as I do of the mating habits of the chrzaszcz. (That's a Polish May bug, students)....

Furthermore, we will not follow the frequently prevalent approach of investing in securities where an attempt to anticipate market action overrides business valuations. Such so-called "fashion" investing has frequently produced very substantial and quick profits in recent years (and currently as I write this in January).

We would have preferred, of course, to have seen the market below cost since our interest was in additional buying, not in selling.

The fact that the stock had risen somewhat above our cost had already slowed down our buying program and thereby reduced ultimate profit.

...We would have been much better off from a long range standpoint if 1966 results had been five percentage points worse and we were continuing to buy substantial quantities of the stock at the depressed prices that might have been expected to prevail in last year's market environment.

(One) investment has substantially out-performed the general market for us during each year (1964, 1965, 1966) that we have held it....The attractiveness and relative certainty of this particular security are what caused me to introduce Ground Rule 7 in November, 1965 to allow individual holdings of up to 40% of our net assets. We spend considerable effort continuously evaluating every facet of the company and constantly testing our hypothesis that this security is superior to alternative investment choices. Such constant evaluation and comparison at shifting prices is absolutely essential to our investment operation.

...In earlier years when the flow of good ideas was more substantial.

...I am not willing to incur risk of substantial permanent capital loss in seeking to better long term performance.

Average bank borrowings during 1966 were well under 10% of average net worth.

(About one stock in which Buffett invested $1.6 million before it soared out of reach): Though our overall gain was $728,141 on an average holding period of six and a half months in 1966, it would have been much more desirable had the stock done nothing for a long period of time while we accumulated a really substantial position.

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1967: (Dow +19.0% BPL: +28.4%)

(July 12 semi-annual update): B-H (Berkshire Hathaway) is experiencing and faces real difficulties in the textile business. While I don't presently foresee any loss in underlying values, I similarly see no prospect of a good return on the assets employed in the textile business. Therefore, this segment of our portfolio will be a substantial drag on our relative performance (as it has been during the first half) if the Dow continues to advance....As a friend of mine says, "Experience is what you find when you're looking for something else."

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(October 9, 1967):
The market environment has changed progressively over the past decade, resulting in a sharp diminution in the number of obvious quantitatively based investment bargains available.

My own personal interests dictate a less compulsive approach to superior investment results than when I was younger and leaner.

Interestingly enough, although I consider myself to be primarily in the quantitative school (and as I write this no one has come back from recess--I may be the only one left in the class), the really sensational ideas I have had over the years have been heavily weighted toward the qualitative side where I have had a "high-probability insight." This is what causes the cash register to really sing. However, it is an infrequent occurrence, as insights usually are.

So the really big money tends to be made by investors who are right on qualitative decisions but, at least in my opinion, the more sure money tends to be made on the obvious quantitative decisions.

...Statistical bargains have tended to disappear over the years. This may be due to the constant combing and re-combing of investments that has occurred during the past twenty years, without an economic convulsion such as that of the '30s to create a negative bias toward equities and spawn hundreds of new bargain securities.

Whatever the cause, the result has been the virtual disappearance of the bargain issue as determined quantitatively--and thereby of our bread and butter. There still may be a few from time to time. There will also be the occasional security where I am really competent to make an important qualitative judgment. This will offer our best chance for large profits. Such instances will, however, be rare. Much of our good performance during the past three years has been due to a single idea of this sort.

(About the stock market and "go-go" mutual funds of the era): ..A self-generating type of activity has set in which leads to larger and larger amounts of money participating on a shorter and shorter times span.

A disturbing corollary is that the vehicle for participation (the particular companies or stocks) becomes progressively less important--at times virtually incidental--as the activity accelerates.

All-out effort makes progressively less sense. I would like to have an economic goal which allows for considerable non-economic activity. This may mean activity outside the field of investments or it simply may mean pursuing lines within the investment field that do not promise the greatest economic reward. An example of the latter might be the controlled investments in a satisfactory (but far from spectacular) controlled business where I liked the people and the nature of the business even though alternative investments offered an expectable higher rate of return. More money would be made buying businesses at attractive prices, than reselling them.

Specifically, our longer term goal will be to achieve the lesser of 9% per annum or a five percentage point advantage over the Dow.

Partners with attractive alternative investment opportunities may logically decide that their funds can be better employed elsewhere....
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(November 1, 1967): ...We also have over $16 million in short-term governments. This makes a present total of over $36 million which clearly will not participate in any upward movement the stock market may have. This does not reflect any market judgment on my part; it simply means I can't find any obviously profitable and safe (from a long-term value standpoint, not a short-term quotational one) places to put the money. We normally enter each year with a few eggs relatively close to hatching; the nest is virtually empty at the moment.

It was a year when profits achieved were in inverse proportion to age--and I am in the geriatric ward, philosophically.

Many investment organizations performed substantially better than BPL, with gains ranging to over 100%. Because of these spectacular results, money, talent and energy are converging in a maximum effort for the achievement of large and quick stock market profits. It looks to me like greatly intensified speculation with concentrated risks--but many of the advocates insist otherwise.

Through our two controlled companies (Diversified Retailing and Berkshire Hathaway), we acquired two new enterprises in 1967, Associated Cotton Shops and National Indemnity (with National Fire & Marine, an affiliated company). (Note: This was the beginning of the insurance empire.)

The satisfying nature of our activity in controlled companies is a minor reason for the moderated investment objectives discussed in the October 9th letter. When I am dealing with people I like, in businesses I find stimulating (what business isn't?), and achieving worthwhile overall returns on capital employed (say, 10-12%), it seems foolish to rush from situation to situation to earn a few more percentage points.

...Controlled operating business at an expected rate of return below that inherent in an aggressive stock market operation.

Last year I referred to one investment which substantially outperformed the general market in 1964, 1965 and 1966 and because of its size (the largest proportion we have ever had in anything--we hit our 40% limit) had a very material impact on our overall results....This excellent performance continued through 1967 and a large portion of total gain was again accounted for by this single security Our holdings of this security have been very substantially reduced and we have nothing in this group remotely approaching the size or potential which formerly existed in this investment.

We begin the new year with net assets of $68,108,088. We had partners with capital of about $1,600,000 withdraw at yearend, primarily because of the reduced objectives announced in the October 9th letter. This makes good sense for them, since most of them have the ability and motivation to surpass our objectives and I am relieved from pushing for results that I probably can't attain under present conditions.

I was also asked whether this was an initial stage in the phasing out of the partnership. The answer to this is, "Definitely, no."

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1968: (Dow +7.7% BPL +45.6%)

...Controlled companies...represented slightly over one-third of net assets at the beginning of the year.

...We cannot make the same sort of money out of permanent ownership of controlled businesses that can be made from buying and re-selling such businesses, or from skilled investment in marketable securities. Nevertheless, they offer a pleasant long term form of activity (when conducted in conjunction with high grade, able people) at satisfactory rates of return.

...One particularly progressive entrepreneur told me he believed in "bold, imaginative accounting."

We live in an investment world populated not by those who must be logically persuaded to believe, but by the hopeful, credulous and greedy, grasping for an excuse to believe.

Our yearend valuation for our seventy per cent interest in Berkshire Hathaway, Inc. will be $31 per share....Berkshire Hathaway has made important progress during the year, warranting the increase from $25 per share used last year....

Every year about this time I get some questions as to whether our "no admittance" policy is still in effect. The answer is unequivocally "yes." This is applied across the board....

Results this year continue to be better than I expected. Despite unusually large holdings of cash equivalent securities throughout much of the year and only a bare trickle of worthwhile ideas, we have managed to achieve reasonably good results measured by the old standards as well as the new ones.

Our backlog of potentially profitable ideas for 1969 is virtually nil.

Some of the so-called "go-go" funds have recently been re-christened "no-go" funds. For example, Gerald Tsai's Manhattan Fund, perhaps the world's best-known aggressive investment vehicle, came in at minus 6.9% for 1968.

(Quoting from one well-known investment manager): "A good money manager cannot maintain a study of securities on a week-by-week or even a day-by-day basis. Securities must be studied in a minute-by-minute program."
Wow! That sort of stuff makes me feel guilty when I go out for a Pepsi.

The classifications (General, Control, etc.) are not iron clad....The initial decision as to category is sometimes arbitrary. Sometimes later classification proves difficult; e.g., a workout that falls through but that I continue to hold for reasons unrelated or only partially related to the original decision (like stubbornness).

The results applicable to each category are dominated by one or two investments. (Note: In other

words: the portfolio is highly concentrated.)

Both of these companies (Associated Cotton Shops and National Indemnity Insurance, both controlled by BPL) earned about 20% on capital employed in their businesses. Among Fortune's "500" (the largest manufacturing entities in the country, starting with General Motors), only 37 companies achieved this figure in 1967, and our boys outshone such mildly better-known (but not better-appreciated) companies as IBM, General Electric, General Motors, Proctor & Gamble, DuPont, Control Data, Hewlett-Packard, etc.

We valued (Berkshire Hathaway) at 25 at yearend 1967 when the market was about 20, and 31 at yearend 1968 when the market was about 37. We would have done the same thing if the markets had been 15 and 50 respectively. ("Price is what you pay, value is what you get").

(In terms of new investment ideas): What came through like the Johnstown flood in 1968 looks more like a leaky faucet in Altoona for 1969.

I can't emphasize too strongly that the quality and quantity of ideas is presently at an all time low--the product of factors mentioned in my October 9th, 1967 letter, which have largely been intensified since then.

We have a number of important negatives operating on our future and, while they shouldn't add up to futility, they certainly don't add up to more than an average of quite moderate profitability.

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1969: (Not a full year)

All quotes are from letter of May 29th:
...It seems to me that: (1) opportunities for investment that are open to the analyst who stresses quantitative factors have virtually disappeared, after rather steadily drying up over the past twenty years; (2) our $100 million of assets further eliminates a large portion of this seemingly barren investment world, since commitments of less than about $3 million cannot have a real impact on our overall performance, and this virtually rules out companies with less than about $100 million of common stock at market value; and (3) a swelling interest in investment performance has created an increasingly short-term oriented and (in my opinion) more speculative market.

As long as I am "on stage", publishing a regular record and assuming responsibility for management of what amounts to virtually 100% of the net worth of many partners, I will never be able to put sustained effort into any non-BPL activity. If I am going to participate publicly, I can't help being competitive. I know I don't want to be totally occupied with out-pacing an investment rabbit all my life. The only way to slow down is to stop.

...I...want all partners to have the option of maintaining their proportional interests in our two controlled companies (Diversified Retailing Company, Inc., and Berkshire Hathaway, Inc.) and one other small "restricted" holding.

I certainly have no desire to sell a good controlled business run by people I like and admire, merely to obtain a fancy price.

...In spite of any factors set forth on the earlier pages, I would continue to operate the Partnership in 1970, or even 1971, if I had some really first class ideas.

I am not attuned to this market environment, and I don't want to spoil a decent record by trying to play a game I don't understand just so I can go out a hero.

Some of you are going to ask, "What do you plan to do?"   I don't have an answer to that question.   I do know that when I am 60, I should be attempting to achieve different personal goals than those which had priority at age 20.

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(End)