An important change at any level of our manufacturing process could require m[illegible] capital expenditures at tomorrow's replacement prices. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 257-258

Because of the uncertainties in knowing when the Company may be called upon to produce substantial sums of cash, and the possibility that this might not occur for a considerable period of time, your directors have felt that we should be as zealous to achieve a realistic return on this portion of our capital as we are on the other funds that are at the time invested in plant, -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 262-265

Our history in this area shows occasional periods of strong prices, regularly followed by heavy imports of goods, severe price cutting and curtailed operations. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 331-332

During another year in which the fire and casualty insurance industry experienced substantial underwriting losses, our insurance subsidiaries achieved significant adjusted underwriting profits. Since establishment of the business in 1941, Mr. Ringwalt has held to the principle of underwriting for a profit—a policy which is frequently talked about within the industry -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 372-375

Our traditional operation experienced a surge in volume as conventional auto insurance markets became more restricted. This is in line with our history as a non-conventional carrier which receives volume gains on a "wave" basis when standard markets are experiencing capacity or underwriting problems. Although our combined loss and expense ratio on the traditional business rose to approximately 100% during the year, our management, led by Jack Ringwalt and Phil Liesche, has the ability and determination to -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 404-407

of capital inaugurated five years ago. It will continue to be the objective of management to improve return on total capitalization (long term debt plus equity), as well as the return on equity capital. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 431-432

When standard markets become tight because of unprofitable industry underwriting, we experience substantial volume increases as producers look to us. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 444-445

We set no volume goals in our insurance business generally—and certainly not in reinsurance—as virtually any volume can be achieved if profitability standards are ignored. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 453-454

In 1971, Illinois National earned well over 2% after tax on average deposits while (1) not using borrowed funds except for very -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 475-475

occasional reserve balancing transactions; (2) maintaining a liquidity position far above average; (3) recording loan losses far below average; and (4) utilizing a mix of over 50% time deposits with all consumer savings accounts receiving maximum permitted interest rates throughout the year. This reflects a superb management job by Gene Abegg and Bob Kline. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 475-478

In all three cases, the founders were major sellers and received significant proceeds in cash—and, in all three cases, the same individuals, Jack Ringwalt, Gene Abegg and Vic Raab, have continued to run the businesses with undiminished energy and imagination -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 502-504

Over-all, we probably would have retained better prospects for the next five years if profits had not risen so dramatically this year. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 514-515

Our seasoned management, headed by Jack Ringwalt and Phil Liesche, will continue to underwrite to produce a profit, although not at the level of 1972, and base our rates on long-term expectations rather than short-term hopes. Although this approach has meant dips in volume from time to time in the past, it has produced excellent long-term results. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 519-521

Management's objective is to achieve a return on capital over the long term which averages somewhat higher than that of American industry generally—while utilizing sound accounting and debt policies. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 569-570

which show signs of continuing in 1974, we have elected to adopt the "lifo" method of inventory pricing. This method more nearly matches current costs against current revenues, and minimizes inventory "profits" included in reported earnings. Further information on this change is included in the footnotes to our financial statements. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 577-580

To date, our big problem has been Texas. In that state we virtually had to start over during 1973 as the initial management we selected proved incapable of underwriting successfully. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 590-591

The question is whether possible lowered accident frequency because of reduced driving will more than offset continuing inflation in medical and repair costs, as well as jury awards. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 594-595

We had significant unrealized depreciation—over $12 million—in our common stock holdings at year-end, as indicated in our financial statements. Nevertheless, we believe that our common stock portfolio at cost represents good value in terms of intrinsic business worth. In spite of the large unrealized loss at year-end, -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 600-602

Diversified Retailing Company, Inc., through subsidiaries, operates a chain of popular-priced women's apparel stores and also conducts a reinsurance business. In the opinion of your management, its most important asset is 16% of the stock of Blue Chip Stamps. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 613-615

19% of that company's outstanding shares. Since year-end, we have increased our holdings so that they now represent approximately 22 1/2%; implementation of the proposed merger with Diversified Retailing Company, Inc. would increase this figure to about 38 1/2%. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 615-617

Blue Chip's trading stamp business has declined drastically over the past year or so, but it has important sources of earning power in its See's Candy Shops subsidiary as well as Wesco Financial Corporation, a 54% owned subsidiary engaged in the savings and loan business. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 630-632 unusual profitability in insurance underwriting. This seemed certain eventually to attract unintelligent competition with consequent inadequate rates. It also has been apparent that many insurance organizations, major as well as minor, have been guilty of significant underreserving of losses, which inevitably produces faulty information as to the true cost of the product being sold. In 1974, these factors, along with a high rate of inflation, combined to produce a rapid erosion in underwriting results. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 664-667

costs of the product we deliver (aula repair, medical payments, compensation benefits, etc.) are increasing at a rate we estimate to be in the area of 1% per month. Of course, this increase doesn't proceed in an even flow but, inexorably, inflation grinds very heavily at the repair services—to humans and to property—that we provide. However, rates virtually have been unchanged in the properly and casualty field for the last few years. With costs moving forward rapidly and prices remaining unchanged, it was not hard to predict what would happen to profit margins. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 667-671

With poor underwriting and with generally weakened capital ratios throughout the insurance industry, such a higher level of liquidity is appropriate and comforting. It eliminates the possible temptation to write business at any price, simply to maintain cash flow, which is a major problem faced by many companies. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 709-711

Therefore, we continue to look for ways to increase further our scale of operations while avoiding major capital investment in new fixed assets which we consider unwise, considering the relatively low returns historically earned on large scale investment in new textile equipment. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 777-779

Our equity investments are heavily concentrated in a few companies which are selected based on favorable economic characteristics, competent and honest management, and a purchase price attractive when measured against the yardstick of value to a private owner. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 816-818

With this approach, stock market fluctuations are of little importance to us—except as they may provide buying opportunities—but business performance is of major importance. On this score we have been delighted with progress made by practically all of the companies in which we now have significant investments. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 820-822

Unusually high liquidity is maintained with obligations of the U. S. Government and its agencies, all due within one year, at yearend amounting to about 75% of demand deposits. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 828-829

In 1975 the thirty largest banks in the United States earned an average of .5% on total assets. The Illinois National earned about four times that much. These same thirty largest banks carried down 7% of operating revenues to net income. Without counting any tax benefits from consolidation, Illinois National carried down 27%. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 831-833

No additional capital has been paid in, and we recommend reading its financial statements on pages 28-34 -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 834-835

K & W Products manufactures specialty automotive chemicals for use in automobile maintenance, such as radiator and block sealants, gasket compounds and fuel and oil additives. The company has extensive trademark or trade name protection for its products, which it manufactures at plants in California and Indiana. Although relatively small, with sales of a little over $2 million, it consistently has generated favorable earnings. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 852-855

When mistakes are made in the pricing of reinsurance, the effects continue for even longer than when similar mistakes are made in direct underwriting. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 897-898

You will notice that our major equity holdings are relatively few. We select such investments on a long-term basis, weighing the same factors as would be involved in the purchase of 100% of an operating business: (1) favorable long-term economic characteristics; (2) competent and honest management; (3) purchase price attractive when measured against the yardstick of value to a private owner; and (4) an industry with which we are familiar and whose long-term business characteristics we feel competent to judge. It is difficult to find investments meeting such a test, and that is one reason for our concentration of holdings. We simply can't find one hundred different securities that conform to our investment requirements. However, we feel quite comfortable concentrating our holdings in the much smaller number that we do identify as attractive. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 942-948

However, insurance operations, led again by the truly outstanding results of Phil Liesche's managerial group at National Indemnity Company, were even better than our optimistic expectations. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 979-980

Since businesses customarily add from year to year to their equity base, we find nothing particularly noteworthy in a management performance combining, say, a 10% increase in equity capital and a 5% increase in earnings per share. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 981-982

It is comforting to be in a business where some mistakes can be made and yet a quite satisfactory overall performance can be achieved. In a sense, this is the opposite case from our textile business where even very good management probably can average only modest results. One of the lessons your management has learned—and, unfortunately, sometimes re-learned—is the importance of being in businesses where tailwinds prevail rather than headwinds. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1015-1018

In addition, reinsurance generates unusually high funds for investment as a percentage of premium volume. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1033-1033

Insurance companies offer standardized policies which can be copied by anyone. Their only products are promises. It is not difficult to be licensed, and rates are an open book. There are no important advantages from trademarks, patents, location, corporate longevity, raw material sources, etc., and very little consumer differentiation to produce insulation from competition. It is commonplace, in corporate annual reports, to stress the difference that people make. Sometimes this is true and sometimes it isn't. But there is no question that the nature of the insurance business magnifies the effect which individual managers have on company performance. We are very fortunate to have the group of managers that are associated with us. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1047-1052

Just as it would be foolish to focus unduly on short-term prospects when acquiring an entire company, we think it equally unsound to become mesmerized by prospective near term earnings or recent trends in earnings when purchasing small pieces of a company; i.e., marketable common stocks. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1060-1061

Capital Cities possesses both extraordinary properties and extraordinary management. And these management skills extend equally to operations and employment of corporate capital. To purchase, directly, properties such as Capital Cities owns would cost in the area of twice our cost of purchase via the stock market, and direct ownership would offer no important advantages to us. While control would give us the opportunity—and the responsibility—to manage operations and corporate resources, we would not be able to provide management in either of those respects equal to that now in place. In effect, we can obtain a better management result through non-control than control. This is an unorthodox view, but one we believe to be sound. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1108-1113

Textile plant and equipment are on the books for a very small fraction of what it would cost to replace such equipment today -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1259-1260

But despite this “bargain cost” of fixed assets, capital turnover is relatively low reflecting required high investment levels in receivables and inventory compared to sales. Slow capital turnover, coupled with low profit margins on sales, inevitably produces inadequate returns on capital. Obvious approaches to improved profit margins involve differentiation of product, lowered manufacturing costs through more efficient equipment or better utilization of people, redirection toward fabrics enjoying stronger market trends, etc. Our management is diligent in pursuing such objectives. The problem, of course, is that our competitors are just as diligently doing the same thing. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1261-1266

The textile industry illustrates in textbook style how producers of relatively undifferentiated goods in capital intensive businesses must earn inadequate returns except under conditions of tight supply or real shortage. As long as excess productive capacity exists, prices tend to reflect direct operating costs rather than capital employed. Such a supply-excess condition appears likely to prevail most of the time in the textile industry, and our expectations are for profits of relatively modest amounts in relation to capital. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1266-1270

very large sums for investment relative to premium volume, and thus gives us reasonably satisfactory overall results. However, underwriting results still are not what they should be and can be. It is very easy to fool yourself regarding underwriting results in reinsurance (particularly in casualty lines involving long delays in settlement), and we believe this situation prevails with many of our competitors. Unfortunately, self-delusion in company reserving almost always leads to inadequate industry rate levels. If major factors in the market don’t know their true costs, the competitive “fall-out” hits all—even those with adequate cost knowledge. George is quite willing to reduce volume significantly, if needed, to achieve satisfactory underwriting, and we have a great deal of confidence in the long term soundness of this business under his direction. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1290-1296

We continue to look for ways to expand our insurance operation. But your reaction to this intent should not be unrestrained joy. Some of our expansion efforts—largely initiated by your Chairman have been lackluster, others have been expensive failures. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1311-1313

It is not easy to buy a good insurance business, but our experience has been that it is easier to buy one than create one. However, we will continue to try both approaches, since the rewards for success in this field can be exceptional. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1314-1316

We get excited enough to commit a big percentage of insurance company net worth to equities only when we find (1) businesses we can understand, (2) with favorable long-term prospects, (3) operated by honest and competent people, and (4) priced very attractively. We usually can identify a small number of potential investments meeting requirements (1), (2) and (3), but (4) often prevents action. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1318-1320

This program of acquisition of small fractions of businesses (common stocks) at bargain prices, for which little enthusiasm exists, contrasts sharply with general corporate acquisition activity, for which much enthusiasm exists. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1331-1333

SAFECO is a much better insurance operation than our own (although we believe certain segments of ours are much better than average), is better than one we could develop and, similarly, is far better than any in which we might negotiate purchase of a controlling interest. Yet our purchase of SAFECO was made at substantially under book value. We paid less than 100 cents on the dollar for the best company in the business, when far more than 100 cents on the dollar is being paid for mediocre companies in corporate transactions. And there is no way to start a new operation—with necessarily uncertain prospects—at less than 100 cents on the dollar. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1371-1375

We are not at all unhappy when our wholly-owned businesses retain all of their earnings if they can utilize internally those funds at attractive rates. Why should we feel differently about retention of earnings by companies in which we hold small equity interests, but where the record indicates even better prospects for profitable employment of capital? (This proposition cuts the other way, of course, in industries with low capital requirements, or if management has a record of plowing capital into projects of low profitability; then earnings should be paid out or used to repurchase shares—often by far the most attractive option for capital utilization.) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1383-1388

Our experience has been that the manager of an already high-cost operation frequently is uncommonly resourceful in finding new ways to add to overhead, while the manager of a tightly-run operation usually continues to find additional methods to curtail costs, even when his costs are already well below those of his competitors. No one has demonstrated this latter ability better than Gene Abegg. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1397-1400

It is a real pleasure to work with managers who enjoy coming to work each morning and, once there, instinctively and unerringly think like owners. We are associated with some of the very best. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1410-1411

The primary test of managerial economic performance is the achievement of a high earnings rate on equity capital employed (without undue leverage, accounting gimmickry, etc.) and not the achievement of consistent gains in earnings per share. In our view, many businesses would be better understood by their shareholder owners, as well as the general public, if managements and financial analysts modified the primary emphasis they place upon earnings per share, and upon yearly changes in that figure. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1436-1439

In measuring long term economic performance—in contrast to yearly performance—we believe it is appropriate to recognize fully any realized capital gains or losses as well as extraordinary items, and also to utilize financial statements presenting equity securities at market value -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1439-1441

probably also is fair to say that the quoted book value in 1964 somewhat overstated the intrinsic value of the enterprise, since the assets owned at that time on either a going concern basis or a liquidating value basis were not worth 100 cents on the dollar. (The liabilities were solid, however.) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1448-1450

That combination—the inflation rate plus the percentage of capital that must be paid by the owner to transfer into his own pocket the annual earnings achieved by the business (i.e., ordinary income tax on dividends and capital gains tax on retained earnings)—can be thought of as an "investor's misery index". When this index exceeds the rate of return earned on equity by the business, the investor's purchasing power (real capital) shrinks even though he consumes nothing at all. We have no corporate solution to this problem; high inflation rates will not help us earn higher rates of return on equity. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1465-1470

Year after year, he produces very large earnings relative to capital employed—realized in cash and not in increased receivables and inventories as in many other retail businesses—in a segment of the market with little growth and unexciting demographics. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1574-1575

In some businesses—a network TV station, for example—it is virtually impossible to avoid earning extraordinary returns on tangible capital employed in the business. And assets in such businesses sell at equally extraordinary prices, one thousand cents or more on the dollar, a valuation reflecting the splendid, almost unavoidable, economic results obtainable. Despite a fancy price tag, the "easy" business may be the better route to go. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1578-1581

Your Chairman made the decision a few years ago to purchase Waumbec Mills in Manchester, New Hampshire, thereby expanding our textile commitment. By any statistical test, the purchase price was an extraordinary bargain; we bought well below the working capital of the business and, in effect, got very substantial amounts of machinery and real estate for less than nothing. But the purchase was a mistake. While we labored mightily, new problems arose as fast as old problems were tamed. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1582-1585

Both our operating and investment experience cause us to conclude that "turnarounds" seldom turn, and that the same energies and talent are much better employed in a good business purchased at a fair price than in a poor business purchased at a bargain price. Although a mistake, the Waumbec acquisition has not been a disaster. Certain portions of the operation are proving to be valuable additions to our decorator line (our strongest franchise) at New Bedford, and it's possible that we may be able to run profitably on a considerably reduced scale at Manchester. However, our original rationale did not prove out. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1585-1589

Phil Liesche is an exception: if business makes sense, he writes it; if it doesn't, he rejects it. It is our policy not to lay off people because of the large fluctuations in work load produced by such voluntary volume changes. We would rather have some slack in the organization from time to time than keep everyone terribly busy writing business on which we are going to lose money. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1601-1603

We think the reinsurance business is a very tough business that is likely to get much tougher. In fact, the influx of capital into the business and the resulting softer price levels for continually increasing exposures may well produce disastrous results for many entrants (of which they may be blissfully unaware until they are in over their heads; much reinsurance business involves an exceptionally "long tail", a characteristic that allows catastrophic current loss experience to fester undetected for many years). -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1610-1613

Present interest rates encourage the obtaining of business at underwriting loss levels formerly regarded as totally unacceptable. Managers decry the folly of underwriting at a loss to obtain investment income, but we believe that many will. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1633-1635

we believe that insurance can be a very good business. It tends to magnify, to an unusual degree, human managerial talent—or the lack of it. We have a number of managers whose talent is both proven and growing. (And, in addition, we have a very large indirect interest in two truly outstanding management groups through our investments in SAFECO and GEICO.) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1641-1644

Overall, we opt for Polonius (slightly restated): "Neither a short-term borrower nor a long-term lender be." -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1733-1734

Your Chairman has a firm belief that owners are entitled to hear directly from the CEO as to what is going on and how he evaluates the business, currently and prospectively. You would demand that in a private company; you should expect no less in a public company. A once-a-year report of stewardship should not be turned over to a staff specialist or public relations consultant who is unlikely to be in a position to talk frankly on a manager-to-owner basis. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1761-1764

Your company is run on the principle of centralization of financial decisions at the top (the very top, it might be added), and rather extreme delegation of operating authority to a number of key managers at the individual company or business unit level. We could just field a basketball team with our corporate headquarters group (which utilizes only about 1500 square feet of space). This approach produces an occasional major mistake that might have been eliminated or minimized through closer operating controls. But it also eliminates large layers of costs and dramatically speeds decision-making. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1791-1795

We have owned 100% of businesses whose reported earnings were not worth close to 100 cents on the dollar to us even though, in an accounting sense, we totally controlled their disposition. (The "control" was theoretical. Unless we reinvested all earnings, massive deterioration in the value of assets already in place would occur. But those reinvested earnings had no prospect of earning anything close to a market return on capital.) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1835-1838

The value to Berkshire Hathaway of retained earnings is not determined by whether we own 100%, 50%, 20% or 1% of the businesses in which they reside. Rather, the value of those retained earnings is determined by the use to which they are put and the subsequent level of earnings produced by that usage. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1839-1841

The competitive nature of corporate acquisition activity almost guarantees the payment of a full—frequently more than full price when a company buys the entire ownership of another enterprise. But the auction nature of security markets often allows finely-run companies the opportunity to purchase portions of their own businesses at a price under 50% of that needed to acquire the same earning power through the negotiated acquisition of another enterprise.) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1850-1853

It is encouraging, moreover, to realize that our record was achieved despite many mistakes. The list is too painful and lengthy to detail here. But it clearly shows that a reasonably competitive corporate batting average can be achieved in spite of a lot of managerial strikeouts. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1864-1866

At present inflation rates, we believe individual owners in medium or high tax brackets (as distinguished from tax-free entities such as pension funds, eleemosynary institutions, etc.) should expect no real long-term return from the average American corporation, even though these individuals reinvest the entire after-tax proceeds from all dividends they receive. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1891-1893

For capital to be truly indexed, return on equity must rise, i.e., business earnings consistently must increase in proportion to the increase in the price level without any need for the business to add to capital—including working capital—employed. (Increased earnings produced by increased investment don’t count.) Only a few businesses come close to exhibiting this ability. And Berkshire Hathaway isn’t one of them. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 1902-1905

GEICO represents the best of all investment worlds—the coupling of a very important and very hard to duplicate business advantage with an extraordinary management whose skills in operations are matched by skills in capital allocation. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2075-2077

We have written in past reports about the disappointments that usually result from purchase and operation of “turnaround” businesses. Literally hundreds of turnaround possibilities in dozens of industries have been described to us over the years and, either as participants or as observers, we have tracked performance against expectations. Our conclusion is that, with few exceptions, when a management with a reputation for brilliance tackles a business with a reputation for poor fundamental economics, it is the reputation of the business that remains intact. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2083-2087

GEICO may appear to be an exception, having been turned around from the very edge of bankruptcy in 1976. It certainly is true that managerial brilliance was needed for its resuscitation, and that Jack Byrne, upon arrival in that year, supplied that ingredient in abundance. But it also is true that the fundamental business advantage that GEICO had enjoyed—an advantage that previously had produced staggering success—was still intact within the company, although submerged in a sea of financial and operating troubles. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2087-2091

GEICO was designed to be the low-cost operation in an enormous marketplace (auto insurance) populated largely by companies whose marketing structures restricted adaptation. Run as designed, it could offer unusual value to its customers while earning unusual returns for itself. For decades it had been run in just this manner. Its troubles in the mid-70s were not produced by any diminution or disappearance of this essential economic advantage. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2091-2094

GEICO’s problems at that time put it in a position analogous to that of American Express in 1964 following the salad oil scandal. Both were one-of-a-kind companies, temporarily reeling from the effects of a fiscal blow that did not destroy their exceptional underlying economics. The GEICO and American Express situations, extraordinary business franchises with a localized excisable cancer (needing, to be sure, a skilled surgeon), should be distinguished from the true “turnaround” situation in which the managers expect—and need—to pull off a corporate Pygmalion. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2094-2098

We find it perfectly satisfying that the nature of our insurance business dictates we buy many minority portions of already well-run businesses (at prices far below our share of the total value of the entire business) that do not need management change, re-direction of cash flow, or sale. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2103-2105

To understand why, we recommend that you read the excellent analysis of property-casualty competitive dynamics done by Barbara Stewart of Chubb Corp. in an October 1980 paper. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2109-2110

But the full implications flowing from massive unrealized bond losses are far more serious than just the immobilization of investment intellect. For the source of funds to purchase and hold those bonds is a pool of money derived from policyholders and claimants (with changing faces)—money which, in effect, is temporarily on deposit with the insurer. As long as this pool retains its size, no bonds must be sold. If the pool of funds shrinks—which it will if the volume of business declines significantly—assets must be sold to pay off the liabilities. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2129-2133

Thus, an insurance company with a bond market value shrinkage approaching stated net worth (of which there are now many) and also faced with inadequate rate levels that are sure to deteriorate further has two options. One option for management is to tell the underwriters to keep pricing according to the exposure involved—“be sure to get a dollar of premium for every dollar of expense cost plus expectable loss cost”. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2134-2137

This ostrich-like behavior—selling the better assets and keeping the biggest losers—while less painful in the short term, is unlikely to be a winner in the long term. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2143-2144

just keep writing business regardless of rate levels and whopping prospective underwriting losses, thereby maintaining the present levels of premiums, assets and liabilities—and then pray for a better day, either for underwriting or for bond prices. There is much criticism in the trade press of “cash flow” underwriting; i.e., writing business regardless of prospective underwriting losses in order to obtain funds to invest at current high interest rates. This second option might properly be termed “asset maintenance” underwriting—the acceptance of terrible business just to keep the assets you now have. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2145-2149

And it also is clear that as long as many large insurers feel compelled to choose that second option, there will be no better day for underwriting. For if much of the industry feels it must maintain premium volume levels regardless of price adequacy, all insurers will have to come close to meeting those prices. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2149-2151

Reinsurance is characterized by extreme ease of entry, large premium payments in advance, and much-delayed loss reports and loss payments. Initially, the morning mail brings lots of cash and few claims. This state of affairs can produce a blissful, almost euphoric, feeling akin to that experienced by an innocent upon receipt of his first credit card. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2172-2174

magnetic lure of such cash-generating characteristics, currently enhanced by the presence of high interest rates, is transforming the reinsurance market into “amateur night”. Without a super catastrophe, industry underwriting will be poor in the next few years. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2174-2176

Leaders, business or otherwise, seldom are deficient in animal spirits and often relish increased activity and challenge. At Berkshire, the corporate pulse never beats faster than when an acquisition is in prospect. Most organizations, business or otherwise, measure themselves, are measured by others, and compensate their managers far more by the yardstick of size than by any other yardstick. (Ask a Fortune 500 manager where his corporation stands on that famous list and, invariably, the number responded will be from the list ranked by size of sales; he may well not even know where his corporation places on the list Fortune just as faithfully compiles ranking the same 500 corporations by profitability.) Many managements apparently were overexposed in impressionable childhood years to the story in which the imprisoned handsome prince is released from a toad’s body by a kiss from a beautiful princess. Consequently, they are certain their managerial kiss will do wonders for the profitability of Company T(arget). -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2274-2281

Such favored business must have two characteristics: (1) an ability to increase prices rather easily (even when product demand is flat and capacity is not fully utilized) without fear of significant loss of either market share or unit volume, and (2) an ability to accommodate large dollar volume increases in business (often produced more by inflation than by real growth) with only minor additional investment of capital. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2288-2291

(1) the management we have elected to join; (2) the future economics of the business; or (3) the price we have paid. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2318-2318

Logically, a company with historic and prospective high returns on equity should retain much or all of its earnings so that shareholders can earn premium returns on enhanced capital. Conversely, low returns on corporate equity would suggest a very high dividend payout so that owners could direct capital toward more attractive areas. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2398-2401

And prices for the insurance coverage, of course, are frozen for the life of the contract. Thus, this year’s sales contracts (“premium written” in the parlance of the industry) determine about one-half of next year’s level of revenue (“premiums earned”). -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2570-2572

destroyed the integrity of many insurers’ balance sheets, forcing them to abandon underwriting discipline and write business at any price in order to avoid negative cash flow. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2617-2618

Commentators continue to talk of the underwriting cycle, usually implying a regularity of rhythm and a relatively constant midpoint of profitability. Our own view is different. We believe that very large, although obviously varying, underwriting losses will be the norm for the industry, and that the best underwriting years in the future decade may appear substandard against the average year of the past decade. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2626-2628

Charlie Munger, Vice Chairman of Berkshire and Chairman of Blue Chip. Irrespective of titles, Charlie and I work as partners in managing all controlled companies. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2673-2674

We prefer a concept of “economic” earnings that includes all undistributed earnings, regardless of ownership percentage. In our view, the value to all owners of the retained earnings of a business enterprise is determined by the effectiveness with which those earnings are used—and not by the size of one’s ownership percentage. If you have owned .01 of 1% of Berkshire during the past decade, you have benefited economically in full measure from your share of our retained earnings, no matter what your accounting system. Proportionately, you have done just as well as if you had owned the magic 20%. But if you have owned 100% of a great many capital-intensive businesses during the decade, retained earnings that were credited fully and with painstaking precision to you under standard accounting methods have resulted in minor or zero economic value. This is not a criticism of accounting procedures. We would not like to have the job of designing a better system. It’s simply to say that managers and investors alike must understand that accounting numbers are the beginning, not the end, of business valuation. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2699-2706

Within this gigantic auction arena, it is our job to select businesses with economic characteristics allowing each dollar of retained earnings to be translated eventually into at least a dollar of market value. Despite a lot of mistakes, we have so far achieved this goal. In doing so, we have been greatly assisted by Arthur Okun’s patron saint for economists—St. Offset. In some cases, that is, retained earnings attributable to our ownership position have had insignificant or even negative impact on market value, while in other major positions a dollar retained by an investee corporation has been translated into two or more dollars of market value. To date, our corporate over-achievers have more than offset the laggards. If we can continue this record, it will validate our efforts to maximize “economic” earnings, regardless of the impact upon “accounting” earnings. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2722-2728

As we look at the major acquisitions that others made during 1982, our reaction is not envy, but relief that we were non-participants. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2730-2731

As we look at the major acquisitions that others made during 1982, our reaction is not envy, but relief that we were non-participants. For in many of these acquisitions, managerial intellect wilted in competition with managerial adrenaline. The thrill of the chase blinded the pursuers to the consequences of the catch. Pascal’s observation seems apt: “It has struck me that all men’s misfortunes spring from the single cause that they are unable to stay quietly in one room.” -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2730-2734 managerial intellect wilted in competition with managerial adrenaline. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2732-2732

In retrospect, our major accomplishment of the year was that a very large purchase to which we had firmly committed was unable to be completed for reasons totally beyond our control. Had it come off, this transaction would have consumed extraordinary amounts of time and energy, all for a most uncertain payoff. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2735-2737

as long as the annual gain in industry premiums written falls well below 10%, you can expect the underwriting picture in the next year to deteriorate. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2942-2943

In a given year, it is possible for an insurer to show almost any profit number it wishes, particularly if it (1) writes “long-tail” business (coverage where current costs can be only estimated, because claim payments are long delayed), (2) has been adequately reserved in the past, or (3) is growing very rapidly. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2946-2948

The conventional wisdom is that 1983 or 1984 will see the worst of underwriting experience and then, as in the past, the “cycle” will move, significantly and steadily, toward better results. We disagree because of a pronounced change in the competitive environment, hard to see for many years but now quite visible. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2953-2955

Businesses in industries with both substantial over-capacity and a “commodity” product (undifferentiated in any customer-important way by factors such as performance, appearance, service support, etc.) are prime candidates for profit troubles. These may be escaped, true, if prices or costs are administered in some manner and thereby insulated at least partially from normal market forces. This administration can be carried out (a) legally through government intervention (until recently, this category included pricing for truckers and deposit costs for financial institutions), (b) illegally through collusion, or (c) “extra-legally” through OPEC-style foreign cartelization (with tag-along benefits for domestic non-cartel operators). -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2956-2961

If, however, costs and prices are determined by full-bore competition, there is more than ample capacity, and the buyer cares little about whose product or distribution services he uses, industry economics are almost certain to be unexciting. They may well be disastrous. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2961-2963

Hence the constant struggle of every vendor to establish and emphasize special qualities of product or service. This works with candy bars (customers buy by brand name, not by asking for a “two-ounce candy bar”) but doesn’t work with sugar (how often do you hear, “I’ll have a cup of coffee with cream and C & H sugar, please”). -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2963-2966

In many industries, differentiation simply can’t be made meaningful. A few producers in such industries may consistently do well if they have a cost advantage that is both wide and sustainable. By definition such exceptions are few, and, in many industries, are non-existent. For the great majority of companies selling “commodity” products, a depressing equation of business economics prevails: persistent over-capacity without administered prices (or costs) equals poor profitability. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2966-2969

Of course, over-capacity may eventually self-correct, either as capacity shrinks or demand expands. Unfortunately for the participants, such corrections often are long delayed. When they finally occur, the rebound to prosperity frequently produces a pervasive enthusiasm for expansion that, within a few years, again creates over-capacity and a new profitless environment. In other words, nothing fails like success. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2969-2972

(From 1950 through 1970, the industry combined ratio averaged 99.0. allowing all investment income plus 1% of premiums to flow through to profits.) The answer lies primarily in the historic methods of regulation and distribution. For much of this century, a large portion of the industry worked, in effect, within a legal quasi-administered pricing system fostered by insurance regulators. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2983-2986

Future profitability of the industry will be determined by current competitive characteristics, not past ones. Many managers have been slow to recognize this. It’s not only generals that prefer to fight the last war. Most business and investment analysis also comes from the rear-view mirror. It seems clear to us, however, that only one condition will allow the insurance industry to achieve significantly improved underwriting results. That is the same condition that will allow better results for the aluminum, copper, or corn producer—a major narrowing of the gap between demand and supply. Unfortunately, there can be no surge in demand for insurance policies comparable to one that might produce a market tightness in copper or aluminum. Rather, the supply of available insurance coverage must be curtailed. “Supply”, in this context, is mental rather than physical: plants or companies need not be shut; only the willingness of underwriters to sign their names need be curtailed. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 2997-3004

Bad profits produce much hand-wringing and finger-pointing. But they do not lead major sources of insurance capacity to turn their backs on very large chunks of business, thereby sacrificing market share and industry significance. Instead, major capacity withdrawals require a shock factor such as a natural or financial “megadisaster”. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3004-3007

first choice of these managers in making acquisitions may be to use cash or debt. But frequently the CEO’s cravings outpace cash and credit resources (certainly mine always have). Frequently, also, these cravings occur when his own stock is selling far below intrinsic business value. This state of affairs produces a moment of truth. At that point, as Yogi Berra has said, “You can observe a lot just by watching.” For shareholders then will find which objective the management truly prefers—expansion of domain or maintenance of owners’ wealth. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3028-3032

If, however, the thirst for size and action is strong enough, the acquirer’s manager will find ample rationalizations for such a value-destroying issuance of stock. Friendly investment bankers will reassure him as to the soundness of his actions. (Don’t ask the barber whether you need a haircut.) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3045-3047

A few favorite rationalizations employed by stock-issuing managements follow: (a) “The company we’re buying is going to be worth a lot more in the future.” (Presumably so is the interest in the old business that is being traded away; future prospects are implicit in the business valuation process. If 2X is issued for X, the imbalance still exists when both parts double in business value.) (b) “We have to grow.” (Who, it might be asked, is the “we”? For present shareholders, the reality is that all existing businesses shrink when shares are issued. Were Berkshire to issue shares tomorrow for an acquisition, Berkshire would own everything that it now owns plus the new business, but your interest in such hard-to-match businesses as See’s Candy

Shops, National Indemnity, etc. would automatically be reduced. If (1) your family owns a 120-acre farm and (2) you invite a neighbor with 60 acres of comparable land to merge his farm into an equal partnership—with you to be managing partner, then (3) your managerial domain will have grown to 180 acres but you will have permanently shrunk by 25% your family's ownership interest in both acreage and crops. Managers who want to expand their domain at the expense of owners might better consider a career in government.) (c) "Our stock is undervalued and we've minimized its use in this deal—but we need to give the selling shareholders 51% in stock and 49% in cash so that certain of those shareholders can get the tax-free exchange they want." (This argument acknowledges that it is beneficial to the acquirer to hold down the issuance of shares, and we like that. But if it hurts the old owners to utilize shares on a 100% basis, it very likely hurts on a 51% basis. After all, a man is not charmed if a spaniel defaces his lawn, just because it's a spaniel and not a St. Bernard. And the wishes of sellers can't be the determinant of the best interests of the buyer—what would happen if, heaven forbid, the seller insisted that as a condition of merger the CEO of the acquirer be replaced?) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3047-3062

The attention given this form of dilution is overdone: current earnings per share (or even earnings per share of the next few years) are an important variable in most business valuations, but far from all powerful. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3083-3084

What really counts is whether a merger is dilutive or anti-dilutive in terms of intrinsic business value (a judgment involving consideration of many variables). We believe calculation of dilution from this viewpoint to be all-important (and too seldom made). -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3086-3088

If Company A announces that it will issue shares to merge with Company B, the process is customarily described as "Company A to Acquire Company B", or "B Sells to A". Clearer thinking about the matter would result if a more awkward but more accurate description were used: "Part of A sold to acquire B", or "Owners of B to receive part of A in exchange for their properties". In a trade, what you are giving is just as important as what you are getting. This remains true even when the final tally on what is being given is delayed. Subsequent sales of common stock or convertible issues, either to complete the financing for a deal or to restore balance sheet strength, must be fully counted in evaluating the fundamental mathematics of the original acquisition. (If corporate pregnancy is going to be the consequence of corporate mating, the time to face that fact is before the moment of ecstasy.) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3088-3094

large purchases (at least $5 million of after-tax earnings), demonstrated consistent earning power (future projections are of little interest to us, nor are "turn-around" situations), businesses earning good returns on equity while employing little or no debt, -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3120-3122

We do not view the company itself as the ultimate owner of our business assets but, instead, view the company as a conduit through which our shareholders own the assets. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3152-3153

Our preference would be to reach this goal by directly owning a diversified group of businesses that generate cash and consistently earn above-average returns on capital. Our second choice is to own parts of similar businesses, attained primarily through purchases of marketable common stocks by our insurance subsidiaries. The price and availability of businesses and the need for insurance capital determine any given year's capital allocation. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3159-3162

A managerial "wish list" will not be filled at shareholder expense. We will not diversify by purchasing entire businesses at control prices that ignore long-term economic consequences to our shareholders. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3174-3176

great caution to suggestions that our poor businesses can be restored to satisfactory profitability by major capital expenditures. (The projections will be dazzling—the advocates will be sincere—but, in the end, major additional investment in a terrible industry usually is about as rewarding as struggling in quicksand.) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3186-3189

Today Nebraska Furniture Mart generates over $100 million of sales annually out of one 200,000 square-foot store. No other home furnishings store in the country comes close to that volume. That single store also sells more furniture, carpets, and appliances than do all Omaha competitors combined. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3214-3216

how I would like, assuming I had ample capital and skilled personnel, to compete with it. I'd rather wrestle grizzlies than compete with Mrs. B and her progeny. They buy brilliantly, they operate at expense ratios competitors don't even dream about, and they then pass on to their customers much of the savings. It's the ideal business—one built upon exceptional value to the customer that in turn translates into exceptional economics for its owners. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3217-3220

Red lights should start flashing if the five-year average annual gain falls much below the return on equity earned over the period by American industry in aggregate. (Watch out for our explanation if that occurs as Goethe observed, "When ideas fail, words come in very handy.") -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3231-3233

Intrinsic business value is an economic concept, estimating future cash output discounted to present value. Book value tells you what has been put in; intrinsic business value estimates what can be taken out. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3240-3242

"The difficulty lies not in the new ideas but in escaping from the old ones." My escape was long delayed, in part because most of what I had been taught by the same teacher had been (and continues to be) so extraordinarily valuable. Ultimately, business experience, direct and vicarious, produced my present strong preference for businesses that possess large amounts of enduring Goodwill and that utilize a minimum of tangible assets. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3259-3262

On balance, the shift from ROP to preprints has negative economic implications for us. Profitability on preprints is less and the business is more subject to competition from alternative means of delivery. Furthermore, a reduction in ROP linage means less absolute space devoted to news (since the news hole percentage remains constant), thereby reducing the utility of the paper to the reader. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3471-3474

Our own combined ratio in 1983 was 121. Since Mike Goldberg recently took over most of the responsibility for the insurance operation, it would be nice for me if our shortcomings could be placed at his doorstep rather than mine. But unfortunately, as we have often pointed out, the insurance business has a long lead-time. Though business policies may be changed and personnel improved, a significant period must pass before the effects are seen. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3583-3586

Potentially, structured settlements and the assumption of loss reserves could become very significant to -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3603-3603

At $1300, there are very few investors who can't afford a Berkshire share. Would -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3637-3638

Assume a very high turnover rate in its shares of 100% per year. If a purchase and sale of the stock each extract commissions of 1% (the rate may be much higher on low-priced stocks) and if the stock trades at book value, the owners of our hypothetical company will pay, in aggregate, 2% of the company's net worth annually for the privilege of transferring ownership. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3649-3651

reputation creates a consumer franchise that allows the value of the product to the purchaser, rather than its production cost, to be the major determinant of selling price. Consumer franchises are a prime source of economic Goodwill. Other sources include governmental franchises not subject to profit regulation, such as television stations, and an enduring position as the low cost producer in an industry. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3727-3730

business like that, therefore, might well have sold for the value of its net tangible assets, or for $18 million. In contrast, we paid $25 million for See's, even though it had no more in earnings and less than half as much in "honest-to-God" assets. Could less really have been more, as our purchase price implied? The answer is "yes"—even if both businesses were expected to have flat unit volume—as long as you anticipated, as we did in 1972, a world of continuous inflation. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3756-3760

And that fact, of course, has been hard for many people to grasp. For years the traditional wisdom—long on tradition, short on wisdom—held that inflation protection was best provided by businesses laden with natural resources, plants and machinery, or other tangible assets ("In Goods We Trust"). It doesn't work that way. Asset-heavy businesses generally earn low rates of return—rates that often barely provide enough capital to fund the inflationary needs of the existing business, with nothing left over for real growth, for distribution to owners, or for acquisition of new businesses. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3776-3781

A good business is not always a good purchase—although it's a good place to look for one. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3808-3809

By making repurchases when a company's market value is well below its business value, management clearly demonstrates that it is given to actions that enhance the wealth of shareholders, rather than to actions that expand management's domain but that do nothing for (or even harm) shareholders. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3975-3977

(Exxon, -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 3985-3986

We try to avoid compromise of these standards, although we find doing nothing the most difficult task of all. (One English statesman attributed his country's greatness in the nineteenth century to a policy of "masterly inactivity". -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4025-4027

The gross margin at NFM is not much more than half of that. NFM's low mark-ups are possible because of its exceptional efficiency: operating expenses (payroll, occupancy, advertising, etc.) are about 16.5% of sales versus 35.6% at Levitz. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4048-4049

All members of the family: (1) apply themselves with an enthusiasm and energy that would make Ben Franklin and Horatio Alger look like dropouts; (2) define with extraordinary realism their area of special competence and act decisively on all matters within it; (3) ignore even the most enticing propositions failing outside of that area of special competence; and, (4) unfailingly behave in a high-grade manner with everyone they deal with. (Mrs. B boils it down to "sell cheap and tell the truth".) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4054-4058

The economics of a dominant newspaper are excellent, among the very best in the business world. Owners, naturally, would like to believe that their wonderful profitability is achieved only because they unfailingly turn out a wonderful product. That comfortable theory wilts before an uncomfortable fact. While first-class newspapers make excellent profits, the profits of third-rate papers are as good or better—as long as either class of paper is dominant within its community. Of course, product quality may have been crucial to the paper in achieving dominance. We believe this was the case at the News, in very large part because of people such as Alfred Kirchhofer who preceded us. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4160-4165

Once dominant, the newspaper itself, not the marketplace, determines just how good or how bad the paper will be. Good or bad, it will prosper. That is not true of most businesses: inferior quality generally produces inferior economics. But even a poor newspaper is a bargain to most citizens simply because of its "bulletin board" value. Other things being equal, a poor product will not achieve quite the level of readership achieved by a first-class product. A poor product, however, will still remain essential to most citizens, and what commands their attention will command the attention of advertisers. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4165-4169

Phil Graham, when publisher of the Washington Post, described the daily newspaper as "a first rough draft of history". Unfortunately, the financial statements of a property/casualty insurer provide, at best, only a first rough draft of earnings and financial condition. The determination of costs is the main problem. Most of an insurer's costs result from losses on claims, and many of the losses that should be charged against the current year's revenue are exceptionally difficult to estimate. Sometimes the extent of these losses, or even their existence, is not known for decades. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4251-4255

The loss expense charged in a property/casualty company's current income statement represents: (1) losses that occurred and were paid during the year; (2) estimates for losses that occurred and were reported to the insurer during the year, but which have yet to be settled; (3) estimates of ultimate dollar costs for losses that occurred during the year but of which the insurer is unaware (termed "IBNR": incurred but not reported); and (4) the net effect of revisions this year of similar estimates for (2) and (3) made in past years. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4255-4259 we paid income taxes calculated on overstated earnings and thereby gave the government money that we didn’t need to. (These overpayments eventually correct themselves, but the delay is long and we don’t receive interest on the amounts we overpaid.) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4294-4296

In our direct business, we have far underestimated the mushrooming tendency of juries and courts to make the “deep pocket” pay, regardless of the factual situation and the past precedents for establishment of liability. We also have underestimated the contagious effect that publicity regarding giant awards has on juries. In the reinsurance area, where we have had our worst experience in under reserving, our customer insurance companies have made the same mistakes. Since we set reserves based on information they supply us, their mistakes have become our mistakes. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4299-4303

In most businesses, of course, insolvent companies run out of cash. Insurance is different: you can be broke but flush. Since cash comes in at the inception of an insurance policy and losses are paid much later, insolvent insurers don’t run out of cash until long after they have run out of net worth. In fact, these “walking dead” often redouble their efforts to write business, accepting almost any price or risk, simply to keep the cash flowing in. With an attitude like that of an embezzler who has gambled away his purloined funds, these companies hope that somehow they can get lucky on the next batch of business and thereby cover up earlier shortfalls. Even if they don’t get lucky, the penalty to managers is usually no greater for a $100 million shortfall than one of $10 million; in the meantime, while the losses mount, the managers keep their jobs and perquisites. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4318-4324

This ceiling on upside potential is an important minus. It should be realized, however, that the great majority of operating businesses have a limited upside potential also unless more capital is continuously invested in them. That is so because most businesses are unable to significantly improve their average returns on equity—even under inflationary conditions, though these were once thought to automatically raise returns. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4353-4356

In many businesses particularly those that have high asset/profit ratios—inflation causes some or all of the reported earnings to become ersatz. The ersatz portion—let’s call these earnings “restricted”—cannot, if the business is to retain its economic position, be distributed as dividends. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4414-4416

No matter how conservative its payout ratio, a company that consistently distributes restricted earnings is destined for oblivion unless equity capital is otherwise infused. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4418-4419

For a number of reasons managers like to withhold unrestricted, readily distributable earnings from shareholders—to expand the corporate empire over which the managers rule, to operate from a position of exceptional financial comfort, etc. But we believe there is only one valid reason for retention. Unrestricted earnings should be retained only when there is a reasonable prospect—backed preferably by historical evidence or, when appropriate, by a thoughtful analysis of the future—that for every dollar retained by the corporation, at least one dollar of market value will be created for owners. This will happen only if the capital retained produces incremental earnings equal to, or above, those generally available to investors. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4428-4433

Owners must guess as to what the rate will average over the intermediate future. However, once an informed guess is made, the rest of the analysis is simple: you should wish your earnings to be reinvested if they can be expected to earn high returns, and you should wish them paid to you if low returns are the likely outcome of reinvestment. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4446-4448

In such cases, shareholders would be far better off if earnings were retained only to expand the high-return business, with the balance paid in dividends or used to repurchase stock (an action that increases the owners’ interest in the exceptional business while sparing them participation in subpar businesses). -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4469-4471

And an iron law of business is that growth eventually dampens exceptional economics. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4552-4552

Ben Graham told a story 40 years ago that illustrates why investment professionals behave as they do: An oil prospector, moving to his heavenly reward, was met by St. Peter with bad news. “You’re qualified for residence”, said St. Peter, “but, as you can see, the compound reserved for oil men is packed. There’s no way to squeeze you in.” After thinking a moment, the prospector asked if he might say just four words to the present occupants. That seemed harmless to St. Peter, so the prospector cupped his hands and yelled, “Oil discovered in hell.” Immediately the gate to the compound opened and all of the oil men marched out to head for the nether regions. Impressed, St. Peter invited the prospector to move in and make himself comfortable. The prospector paused. “No,” he said, “I think I’ll go along with the rest of the boys. There might be some truth to that rumor after all.” -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4584-4590

We thus benefited from four factors: a bargain purchase price, a business with fine underlying economics, an able management concentrating on the interests of shareholders, and a buyer willing to pay full business value. While that last factor is the only one that produces reported earnings, we consider identification of the first three to be the key to building value for Berkshire shareholders. In selecting common stocks, we devote our attention to attractive purchases, not to the possibility of attractive sales. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4679-4682

Our Vice Chairman, Charlie Munger, has always emphasized the study of mistakes rather than successes, both in business and other aspects of life. He does so in the spirit of the man who said: “All I want to know is where I’m going to die so I’ll never go there.” You’ll immediately see why we make a good team: Charlie likes to study errors and I have generated ample material for him, particularly in our textile and insurance businesses. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4696-4699

Split 2-for-1 in 1965, the stock now sells at 34—on an adjusted basis, just a little over its $60 price in 1964. Meanwhile, the CPI has more than tripled. Therefore, each share commands about one-third the purchasing power it did at the end of 1964. Regular dividends have been paid but they, too, have shrunk significantly in purchasing power. This devastating outcome for the shareholders indicates what can happen when much brain power and energy are applied to a faulty premise. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4759-4762

good managerial record (measured by economic returns) is far more a function of what business boat you get into than it is of how effectively you row (though intelligence and effort help considerably, of course, in any business, good or bad). -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4765-4766 originally cost us about $13 million, including $2 million spent in 1980-84, and had a current book value of $866,000 (after accelerated depreciation). Though no sane management would have made the investment, the equipment could have been replaced new for perhaps $30-$50 million. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4774-4776

the economic goodwill attributable to two paper routes in Buffalo—or a single See's candy store—considerably exceeds the proceeds we received from this massive collection of tangible assets that not too many years ago, under different competitive conditions, was able to employ over 1,000 people. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4778-4780

illustrates very well the power of economic goodwill during an inflationary period (a phenomenon explained in detail in the 1983 annual report). The financial characteristics of these businesses have allowed us to use a very large portion of the earnings they generate elsewhere. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4794-4796

Many corporate compensation plans reward managers handsomely for earnings increases produced solely, or in large part, by retained earnings—i.e., earnings withheld from owners. For example, ten-year, fixed-price stock options are granted routinely, often by companies whose dividends are only a small percentage of earnings. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4807-4809

Many stock options in the corporate world have worked in exactly that fashion: they have gained in value simply because management retained earnings, not because it did well with the capital in its hands. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4820-4822

Any outsider wanting to secure such an option would be required to pay fully for capital added during the option period. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4825-4826

Managers regularly engineer ten-year, fixed-price options for themselves and associates that, first, totally ignore the fact that retained earnings automatically build value and, second, ignore the carrying cost of capital. As a result, these managers end up profiting much as they would have had they had an option on that savings account that was automatically building up in value. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4827-4830

An owner must weigh upside potential against downside risk; an option holder has no downside. In fact, the business project in which you would wish to have an option frequently is a project in which you would reject ownership. (I'll be happy to accept a lottery ticket as a gift—but I'll never buy one.) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4841-4844

they should have built into them a retained-earnings or carrying-cost factor. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4852-4853

"Performance", furthermore, is defined in different ways depending upon the underlying economics of the business: in some our managers enjoy tailwinds not of their own making, in others they fight unavoidable headwinds. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4867-4868

A partial explanation for the surge in the loss figures is all the additions to reserves that the industry made in 1985. As results for the year were reported, the scene resembled a revival meeting: shouting "I've sinned, I've sinned", insurance managers rushed forward to confess they had under reserved in earlier years. Their corrections significantly affected 1985 loss numbers. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4923-4926

First, commodity businesses achieve good levels of profitability only when prices are fixed in some manner or when capacity is short. Second, managers quickly add to capacity when prospects start to improve and capital is available. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4932-4934

the typical commodity business, furthermore, such as aluminum or steel, a long gestation precedes the birth of additional capacity. In the insurance industry, capital can be secured instantly. Thus, any capacity shortage can be eliminated in short order. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4940-4942

Lately, however, the light has not only been dim but also grossly misleading in the images it has revealed. That is, the courts' tendency to grant awards that are both huge and lacking in precedent makes reinsurers' usual extrapolations or inferences from past data a formula for disaster. Out with Patrick Henry and in with Pogo: "The future ain't what it used to be." -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4967-4970

Inequities of this sort have been particularly pronounced in lines of insurance in which much change was occurring and losses were soaring; e.g., professional malpractice, D & O, products liability, etc. Given these circumstances, it is not surprising that issuing companies remained enthusiastic about writing business long after premiums became woefully inadequate on a gross basis. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4974-4977

On the part of the business kept, the company's underwriting loss was less than $200 million—an excellent result in that year. Meanwhile, the part laid off produced a loss of over $1.5 billion for the reinsurers. Thus, the issuing company wrote at a combined ratio of well under 110 while its reinsurers, participating in precisely the same policies, came in considerably over 140. This result was not attributable to natural catastrophes; it came from run-of-the-mill insurance losses (occurring, however, in surprising frequency and size). The issuing company's 1985 report is not yet available, but I would predict it will show that dramatically unbalanced results continued. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 4979-4984

In any business, insurance or otherwise, "except for" should be excised from the lexicon. If you are going to play the game, you must count the runs scored against you in all nine innings. Any manager who consistently says "except for" and then reports on the lessons he has learned from his mistakes may be missing the only important lesson—namely, that the real mistake is not the act, but the actor. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5013-5016

We hope to develop more of this business, and industry conditions suggest that we could: a significant number of companies are generating more business than they themselves can prudently handle. Our financial strength makes us an attractive partner for such companies. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5042-5044

(We are enormously indebted to those academics: what could be more advantageous in an intellectual contest—whether it be bridge, chess, or stock selection than to have opponents who have been taught that thinking is a waste of energy?) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5083-5085

We sometimes enter the arbitrage field when we have more money than ideas, -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5105-5105

For Cap Cities, ABC is a major undertaking whose economics are likely to be unexciting over the next few years. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5116-5117

(No matter how great the talent or effort, some things just take time: you can't produce a baby in one month by getting nine women pregnant.) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5118-5119

As evidence of our confidence, we have executed an unusual agreement: for an extended period Tom, as CEO (or Dan, should he be CEO) votes our stock. This arrangement was initiated by Charlie and me, not by Tom. We also have restricted ourselves in various ways regarding sale of our shares. The object of these restrictions is to make sure that our block does not get sold to anyone who is a large holder (or intends to become a large holder) without the approval of management, an arrangement similar to ones we initiated some years ago at GEICO and Washington Post. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5119-5122

new ventures, turnarounds, auction-like sales, and the ever-popular (among brokers) "I'm-sure-something-will-work-out-if-you-people-get-to-know-each-other". None of these attracts us in the least. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5179-5180

Such purchases appeal to us only when we are very comfortable with both the economics of the business and the ability and integrity of the people running the operation. We prefer large transactions: in the unusual case we might do something as small as $50 million (or even smaller), but our preference is for commitments many times that size. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5182-5184

Charlie Munger, our Vice Chairman, and I really have only two jobs. One is to attract and keep outstanding managers to run our various operations. This hasn't been all that difficult. Usually the managers came with the companies we bought, having demonstrated their talents throughout careers that spanned a wide variety of business circumstances. They were managerial stars long before they knew us, and our main contribution has been to not get in their way. This approach seems elementary: if my job were to manage a golf team—and if Jack Nicklaus or Arnold Palmer were willing to play for me—neither would get a lot of directives from me about how to swing. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5225-5229

"If each of us hires people who are smaller than we are, we shall become a company of dwarfs. But, if each of us hires people who are bigger than we are, we shall become a company of giants." -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5236-5237

Obviously, the future results of a business earning 23% annually and retaining it all are far more affected by today's capital allocations than are the results of a business earning 10% and distributing half of that to shareholders. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5247-5249

Meanwhile, we had no new ideas in the marketable equities field, an area in which once, only a few years ago, we could readily employ large sums in outstanding businesses at very reasonable prices. So our main capital allocation moves in 1986 were to pay off debt and stockpile funds. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5254-5256

It's easy to overlook what I consider to be the critical lesson of the Mrs. B saga: at 93, Omaha based Board Chairmen have yet to reach their peak. Please file this fact away to consult before you mark your ballot at the 2024 annual meeting of Berkshire. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5382-5383

If our success were to depend upon insights we developed through plant inspections, Berkshire would be in big trouble. Rather, in considering an acquisition, we attempt to evaluate the economic characteristics of the business—its competitive strengths and weaknesses—and the quality of the people we will be joining. Fechheimer was a standout in both respects. In addition to Bob and George Heldman, who are in their mid-60s—spring chickens by our standards—there are three members of the next generation, Gary, Roger and Fred, to insure continuity. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5437-5441

When the investment income that an insurer earns from holding on to policyholders' funds ("the float") is taken into account, a combined ratio in the 107-112 range typically produces an overall break-even result, exclusive of earnings on the funds provided by shareholders. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5485-5487

Nevertheless, underwriting results in 1987, assuming they are not dragged down by a major natural catastrophe, will again improve materially because price increases are recognized in revenues on a lagged basis. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5498-5500

And it works no hardship on our employees: we don't engage in layoffs when we experience a cyclical slowdown at one of our generally-profitable insurance operations. This no-layoff practice is in our self-interest. Employees who fear that large layoffs will accompany sizable reductions in premium volume will understandably produce scads of business through thick and thin (mostly thin). -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5527-5529

When insurance executives belatedly establish proper reserves, they often speak of "reserve strengthening," a term that has a rather noble ring to it. They almost make it sound as if they are adding extra layers of strength to an already-solid balance sheet. That's not the case: instead the term is a euphemism for what should more properly be called "correction of previous untruths" (albeit non-intentional ones). -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5543-5546

These are not only terrific figures but, fully as important, they have been achieved in the right way. Lou has consistently invested in undervalued common stocks that, individually, were unlikely to present him with a permanent loss and that, collectively, were close to risk-free. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5582-5584

Our goal is more modest: we simply attempt to be fearful when others are greedy and to be greedy only when others are fearful. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5598-5598

We continue to periodically employ money in the arbitrage field. However, unlike most arbitrageurs, who purchase dozens of securities each year, we purchase only a few. We restrict ourselves to large deals that have been announced publicly and do not bet on the come. Therefore, our potential profits are apt to be small; but, with luck, our disappointments will also be few. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5609-5611

Arbitrage is an alternative to Treasury Bills as a short-term parking place for money—a choice that combines potentially higher returns with higher risks. To date, our returns from the funds committed to arbitrage have been many times higher than they would have been had we left those funds in Treasury Bills. Nonetheless, one bad experience could change the scorecard markedly. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5614-5616

What determines the outcome is the strength of the corporation's business franchise and whether the profitability of that franchise is regulated. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5705-5706

"owner earnings." These represent (a) reported earnings plus (b) depreciation, depletion, amortization, and certain other non-cash charges such as Company N's items (1) and (4) less (c) the average annual amount of capitalized expenditures for plant and equipment, etc. that the business requires to fully maintain its long-term competitive position and its unit volume. (If the business requires additional working capital to maintain its competitive position and unit volume, the increment also should be included in (c) . However, businesses following the LIFO inventory method usually do not require additional working capital if unit volume does not change.) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5914-5918

When this imperative exists—that is, when (c) exceeds (b)—GAAP earnings overstate owner earnings. Frequently this overstatement is substantial. The oil industry has in recent years provided a conspicuous example of this phenomenon. Had most major oil companies spent only (b) each year, they would have guaranteed their shrinkage in real terms. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5930-5933

All of this points up the absurdity of the "cash flow" numbers that are often set forth in Wall Street reports. These numbers routinely include (a) plus (b)—but do not subtract (c) . Most sales brochures of investment bankers also feature deceptive presentations of this kind. These imply that the business being offered is the commercial counterpart of the Pyramids—forever state-of-the-art, never needing to be replaced, improved or refurbished. Indeed, if all U.S. corporations were to be offered simultaneously for sale through our leading investment bankers—and if the sales brochures describing them were to be believed—governmental projections of national plant and equipment spending would have to be slashed by 90%. "Cash Flow", true, may serve as a shorthand of some utility in descriptions of certain real estate businesses or other enterprises that make huge initial outlays and only tiny outlays thereafter. A company whose only holding is a bridge or an extremely long-lived gas field would be an example. But "cash flow" is meaningless in such businesses as manufacturing, retailing, extractive companies, and utilities because, for them, (c) is always significant. To be sure, businesses of this kind may in a given year be able to defer capital spending. But over a five- or ten-year period, they must make the investment—or the business decays. Why, then, are "cash flow" numbers so popular today? In answer, we confess our cynicism: we believe these numbers are frequently used by marketers of businesses and securities in attempts to justify the unjustifiable (and thereby to sell what should be the unsalable). When (a)—that is, GAAP earnings—looks by itself inadequate to service debt of a junk bond or justify a foolish stock price, how convenient it becomes for salesmen to focus on (a) + (b). But you shouldn't add (b) without subtracting (c) : though dentists correctly claim that if you ignore your teeth they'll go away, the same is not true for (c) . The company or investor believing that the debt-servicing ability or the equity valuation of an enterprise can be measured by totaling (a) and (b) while ignoring (c) is headed for certain trouble. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5933-5948

Thus, pre-tax earnings on the equity capital employed by these businesses amounted to $178 million. And this equity—again on an historical-cost basis—was only $175 million. If these seven business units had operated as a single company, their 1987 after-tax earnings would have been approximately $100 million—a return of about 57% on equity capital -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5976-5979

First, the current business value of these seven units is far above their historical book value and also far above the value at which they are carried on Berkshire's balance sheet. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5987-5988

Second, because so little capital is required to run these businesses, they can grow while concurrently making almost all of their earnings available for deployment in new opportunities. Third, these businesses are run by truly extraordinary managers. The Blumkins, the Heldmans, Chuck Huggins, Stan Lipsey, and Ralph Schey all meld unusual talent, energy and character to achieve exceptional financial results. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5988-5991

With managers like ours, my partner, Charlie Munger, and I have little to do with operations. in fact, it is probably fair to say that if we did more, less would be accomplished. We have no corporate meetings, no corporate budgets, and no performance reviews (though our managers, of course, oftentimes find such procedures useful at their operating units). After all, what can we tell the Blumkins about home furnishings, or the Heldmans about uniforms? -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 5998-6001

appendixes to my letters in the 1983 and 1986 annual reports, I explained why this form of presentation seems to us to be more useful to investors and managers than the standard GAAP presentation, -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6008-6009

There's not a lot new to report about these businesses—and that's good, not bad. Severe change and exceptional returns usually don't mix. Most investors, of course, behave as if just the opposite were true. That is, they usually confer the highest price-earnings ratios on exotic-sounding businesses that hold out the promise of feverish change. That prospect lets investors fantasize about future profitability rather than face today's business realities. For such investor-dreamers, any blind date is preferable to one with the girl next door, no matter how desirable she may be. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6075-6079

But a business that constantly encounters major change also encounters many chances for major error. Furthermore, economic terrain that is forever shifting violently is ground on which it is difficult to build a fortress-like business franchise. Such a franchise is usually the key to sustained high returns. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6082-6084

Only 25 of the 1,000 companies met two tests of economic excellence—an average return on equity of over 20% in the ten years, 1977 through 1986, and no year worse than 15%. These business superstars were also stock market superstars: During the decade, 24 of the 25 outperformed the S&P

500. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6084-6086

Berkshire's experience has been similar. Our managers have produced extraordinary results by doing rather ordinary things—but doing them exceptionally well. Our managers protect their franchises, they control costs, they search for new products and markets that build on their existing strengths and they don't get diverted. They work exceptionally hard at the details of their businesses, and it shows. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6091-6094

You'll enjoy an anonymous letter I received last August: "Sorry to see Berkshire profits fall in the second quarter. One way you may gain back part of your lost. (sic) Check the pricing at The Furniture Mart. You will find that they are leaving 10% to 20% on the table. This additional profit on $140 million of sells (sic) is $28 million. Not small change in anyone's pocket! Check out other furniture, carpet, appliance and T.V. dealers. Your raising prices to a reasonable profit will help. Thank you. /signed/ A Competitor." -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6106-6110

We neither understand the adding of unneeded people or activities because profits are booming, nor the cutting of essential people or activities because profitability is shrinking. That kind of yo-yo approach is neither business-like nor humane. Our goal is to do what makes sense for Berkshire's customers and employees at all times, and never to add the unneeded. ("But what about the corporate jet?" you rudely ask. Well, occasionally a man must rise above principle.) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6128-6131

Whenever shortages appear, the typical manager simply can't wait to expand capacity and thereby plug the hole through which money is showering upon him. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6216-6217

We do not have in mind any time or price for sale. Indeed, we are willing to hold a stock indefinitely so long as we expect the business to increase in intrinsic value at a satisfactory rate. When investing, we view ourselves as business analysts—not as market analysts, not as macroeconomic analysts, and not even as security analysts. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6293-6295

Indeed, if you aren't certain that you understand and can value your business far better than Mr. Market, you don't belong in the game. As they say in poker, "If you've been in the game 30 minutes and you don't know who the patsy is, you're the patsy." -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6310-6312

We are quite content to hold any security indefinitely, so long as the prospective return on equity capital of the underlying business is satisfactory, management is competent and honest, and the market does not overvalue the business. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6328-6330

In effect, we view these investments exactly like our successful controlled businesses—a permanent part of Berkshire rather than merchandise to be disposed of once Mr. Market offers us a sufficiently high price. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6331-6332

"Develop your eccentricities while you are young. That way, when you get old, people won't think you're going ga-ga.") -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6336-6337

To many in that arena, both companies and stocks are seen only as raw material for trades. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6337-6338

For that reason, we would rather achieve a return of X while associating with people whom we strongly like and admire than realize 110% of X by exchanging these relationships for uninteresting or unpleasant ones. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6339-6341

(It must be noted that your Chairman, always a quick study, required only 20 years to recognize how important it was to buy good businesses. In the interim, I searched for "bargains"—and had the misfortune to find some. My punishment was an education in the economics of short-line farm implement manufacturers, third-place department stores, and New England textile manufacturers.) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6356-6359

After ten years on the job, a CEO whose company annually retains earnings equal to 10% of net worth will have been responsible for the deployment of more than 60% of all the capital at work in the business. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6374-6375

Instead of focusing on what businesses will do in the years ahead, many prestigious money managers now focus on what they expect other money managers to do in the days ahead. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6411-6412

If you've thought that investment advisors were hired to invest, you may be bewildered by this technique. After buying a farm, would a rational owner next order his real estate agent to start selling off pieces of it whenever a neighboring property was sold at a lower price? Or would you sell your house to whatever bidder was available at 9:31 on some morning merely because at 9:30 a similar house sold for less than it would have brought on the previous day? -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6417-6420

During the break in October, a few stocks fell to prices that interested us, but we were unable to make meaningful purchases before they rebounded. At yearend 1987 we had no major common stock investments (that is, over $50 million) other than those we consider permanent or arbitrage holdings. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6429-6431

Though we've never made an exact calculation, I believe that overall we have averaged annual pre-tax returns of at least 25% from arbitrage. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6464-6465

Our only $50 million-plus arbitrage position at yearend 1987 was 1,096,200 shares of Allegis, with a cost of $76 million and a market value of $78 million. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6466-6467

One was various Texaco, Inc. bonds with short maturities, all purchased after Texaco went into bankruptcy. Were it not for the extraordinarily strong capital position of our insurance companies, it would be inappropriate for us to buy defaulted bonds. At prices prevailing after Texaco's bankruptcy filing, however, we regarded these issues as by far the most attractive bond investment available to us. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6468-6471

On a worst-case basis with respect to the Pennzoil litigation, we felt the bonds were likely to be worth about what we paid for them. Given a sensible settlement, which seemed likely, we expected the bonds to be worth considerably more. At yearend our Texaco bonds were carried on our books at $104 million and had a market value of $119 million. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6471-6473

This unpredictability is one of the reasons why our participation is in the form of a convertible preferred. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6478-6479

Berkshire's earnings come from many diverse and well-entrenched businesses; these businesses seldom require much capital investment; what debt we have is structured well; and we maintain major holdings of liquid assets. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6514-6515

Unlike many in the business world, we prefer to finance in anticipation of need rather than in reaction to it. A business obtains the best financial results possible by managing both sides of its balance sheet well. This means obtaining the highest-possible return on assets and the lowest-possible cost on liabilities. It would be convenient if opportunities for intelligent action on both fronts coincided. However, reason tells us that just the opposite is likely to be the case: Tight money conditions, which translate into high costs for liabilities, will create the best opportunities for acquisitions, and cheap money will cause assets to be bid to the sky. Our conclusion: Action on the liability side should sometimes be taken independent of any action on the asset side. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6516-6522

The scene is K & W Products, a small Berkshire subsidiary that produces automotive compounds. For years K & W did well, but in 1985-86 it stumbled badly, as it pursued the unattainable to the neglect of the achievable. Charlie, who oversees K & W, knew there was no need to consult me. Instead, he called Harry, now 68 years old, made him CEO, and sat back to await the inevitable. He didn't wait long. In 1987 K & W's profits set a record, up more than 300% from 1986. And, as profits went up, capital employed went down: K & W's investment in accounts receivable and inventories has decreased 20%. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6550-6554

Buffalo News, Fechheimer, Kirby, Nebraska Furniture Mart, Scott Fetzer Manufacturing Group, See's, and World Book. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6595-6596

With no benefit from financial leverage, this group earned about 67% on average equity capital. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6598-6599

urge you to read Charlie Munger's letter, which starts on page 52. It contains the best description I have seen of the events that produced the present savings-and-loan crisis. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6672-6673

Last year I stated unequivocally that pre-tax margins at The Buffalo News would fall in 1988. That forecast would have proved correct at almost any other newspaper our size or larger. But Stan Lipsey—bless him—has managed to make me look foolish. Though we increased our prices a bit less than the industry average last year, and though our newsprint costs and wage rates rose in line with industry norms, Stan actually improved margins a tad. No one in the newspaper business has a better managerial record. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6754-6758

Neither furniture retailing nor uniform manufacturing has inherently attractive economics. In these businesses, only exceptional managements can deliver high returns on invested capital. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6770-6772

Other fundamentals at both businesses are: (1) single store operations featuring huge inventories that provide customers with an enormous selection across all price ranges, (2) daily attention to detail by top management, (3) rapid turnover, (4) shrewd buying, and (5) incredibly low expenses. The combination of the last three factors lets both stores offer everyday prices that no one in the country comes close to matching. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6795-6798

Take the breakfast cereal industry, whose return on invested capital is more than double that of the auto insurance industry (which is why companies like Kellogg and General Mills sell at five times book value and most large insurers sell close to book). The cereal companies regularly impose price increases, few of them related to a significant jump in their costs. Yet not a peep is heard from consumers. But when auto insurers raise prices by amounts that do not even match cost increases, customers are outraged. If you want to be loved, it's clearly better to sell high-priced corn flakes than low-priced auto insurance. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6850-6854

Because of the commodity characteristics of the industry, most insurers earn mediocre returns and therefore have little or no economic goodwill to lose if they are forced by government to leave the auto insurance business. But GEICO, because it is a low-cost producer able to earn high returns on equity, has a huge amount of economic goodwill at risk. In turn, so do we. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6864-6867

(1) long-term common stock investments, (2) medium-term fixed-income securities, (3) long-term fixed-income securities, (4) short-term cash equivalents, and (5) short-term arbitrage commitments. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6884-6885

At too many companies, the boss shoots the arrow of managerial performance and then hastily paints the bullseye around the spot where it lands. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6917-6918

At board meetings, criticism of the CEO's performance is often viewed as the social equivalent of belching. No such inhibitions restrain the office manager from critically evaluating the substandard typist. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6925-6926

But the management failings that Charlie and I have seen make us thankful that we are linked with the managers of our three permanent holdings. They love their businesses, they think like owners, and they exude integrity and ability. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6927-6929

Our holdings of Freddie Mac are the maximum allowed by law, and are extensively described by Charlie in his letter. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6933-6934

At such times, arbitrage sometimes promises much greater returns than Treasury Bills and, equally important, cools any temptation we may have to relax our standards for long-term investments -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6966-6967

Some people might call this scalping; it won't surprise you that practitioners opted for the French term, arbitrage. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6972-6973

The architect of Rockwood's restructuring was an unknown, but brilliant Chicagoan, Jay Pritzker, then 32. If you're familiar with Jay's subsequent record, you won't be surprised to hear the action worked out rather well for Rockwood's continuing shareholders also. From shortly before the tender until shortly after it, Rockwood stock appreciated from 15 to 100, even though the company was experiencing large operating losses. Sometimes there is more to stock valuation than price-earnings ratios. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6986-6990

To evaluate arbitrage situations you must answer four questions: (1) How likely is it that the promised event will indeed occur? (2) How long will your money be tied up? (3) What chance is there that something still better will transpire—a competing takeover bid, for example? and (4) What will happen if the event does not take place because of anti-trust action, financing glitches, etc.? -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 6994-6997

We do not have, never have had, and never will have an opinion about where the stock market, interest rates, or business activity will be a year from now. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7054-7055

Observing correctly that the market was frequently efficient, they went on to conclude incorrectly that it was always efficient. The difference between these propositions is night and day. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7066-7067

Unleveraged returns averaged 20% per year. Starting in 1956, I applied Ben Graham's arbitrage principles, first at Buffett Partnership and then Berkshire. Though I've not made an exact calculation, I have done enough work to know that the 1956-1988 returns averaged well over 20%. (Of course, I operated in an environment far more favorable than Ben's; he had 1929-1932 to contend with.) All of the conditions are present that are required for a fair test of portfolio performance: (1) the three organizations traded hundreds of different securities while building this 63-year record; (2) the results are not skewed by a few fortunate experiences; (3) we did not have to dig for obscure facts or develop keen insights about products or managements—we simply acted on highly-publicized events; and (4) our arbitrage positions were a clearly identified universe—they have not been selected by hindsight. Over the 63 years, the general market delivered just under a 10% annual return, including dividends. That means $1,000 would have grown to $405,000 if all income had been reinvested. A 20% rate of return, however, would have produced $97 million. That strikes us as a statistically-significant differential that might, conceivably, arouse one's curiosity. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7070-7078

An investor cannot obtain superior profits from stocks by simply committing to a specific investment category or style. He can earn them only by carefully evaluating facts and continuously exercising discipline. Investing in arbitrage situations, per se, is no better a strategy than selecting a portfolio by throwing darts. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7088-7090

I have known many professors of finance and investments but I have never seen any, except for Ben Graham, who was the match of Dave. The proof of his talent is the record of his students: No other teacher of investments has sent forth so many who have achieved unusual success. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7119-7121

In Berkshire's investments, Charlie and I have employed the principles taught by Dave and Ben Graham. Our prosperity is the fruit of their intellectual tree. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7125-7126

What counts, however, is intrinsic value—the figure indicating what all of our constituent businesses are rationally worth. With perfect foresight, this number can be calculated by taking all future cash flows of a business—in and out—and discounting them at prevailing interest rates. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7165-7167

We will continue to benefit from good gains in business value that we feel confident our portfolio companies will make. But our "catch-up" rewards have been realized, which means we ll have to settle for a single-dip in the future. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7179-7181

In a finite world, high growth rates must self-destruct. If the base from which the growth is taking place is tiny, this law may not operate for a time. But when the base balloons, the party ends: A high growth rate eventually forges its own anchor. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7181-7183

"That means four doublings an hour, and 96 doublings a day. Although a bacterium weighs only about a trillionth of a gram, its descendants, after a day of wild asexual abandon, will collectively weigh as much as a mountain…in two days, more than the sun—and before very long, everything in the universe will be made of bacteria." Not to worry, says Sagan: Some obstacle always impedes this kind of exponential growth. "The bugs run out of food, or they poison each other, or they are shy about reproducing in public." -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7184-7188

In economic terms, the liability resembles an interest-free loan from the U.S. Treasury that comes due only at our election (unless, of course, Congress moves to tax gains before they are realized). This "loan" is peculiar in other respects as well: It can be used only to finance the ownership of the particular, appreciated stocks and it fluctuates in size—daily as market prices change and periodically if tax rates change. In effect, this deferred tax liability is equivalent to a very large transfer tax that is payable only if we elect to move from one asset to another. Indeed, we sold some relatively small holdings in 1989, incurring about $76 million of "transfer" tax on $224 million of gains. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7205-7210

Because of the way the tax law works, the Rip Van Winkle style of investing that we favor—if successful—has an important mathematical edge over a more frenzied approach. Let's look at an extreme comparison. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7210-7211

The sole reason for this staggering difference in results would be the timing of tax payments. Interestingly, the government would gain from Scenario 2 in exactly the same 27:1 ratio as we—taking in taxes of $356,500 vs. $13,000—though, admittedly, it would have to wait for its money. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7216-7218

We have not, we should stress, adopted our strategy favoring long-term investment commitments because of these mathematics. Indeed, it is possible we could earn greater after-tax returns by moving rather frequently from one investment to another. Many years ago, that's exactly what Charlie and I did. Now we would rather stay put, even if that means slightly lower returns. Our reason is simple: We have found splendid business relationships to be so rare and so enjoyable that we want to retain all we develop. This decision is particularly easy for us because we feel that these relationships will producegood—though perhaps not optimal—financial results. Considering that, we think it makes little sense for us to give up time with people we know to be interesting and admirable for time with others we do not know and who are likely to have human qualities far closer to average. That would be akin to marrying for money—a mistake under most circumstances, insanity if one is already rich. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7218-7225

For our intrinsic business value to grow at an average of 15% per year, our “look-through” earnings must grow at about the same pace. We ll need plenty of help from our present investees, and also need to add a new one from time to time, in order to reach this 15% goal. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7312-7314

Because of the huge volume it does at one location, the store can maintain an enormous selection across all price ranges. For the same reason, it can hold its expense ratio to about one-third that prevailing at jewelry stores offering comparable merchandise. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7328-7329

A large and intelligently-utilized news hole, however, attracts a wide spectrum of readers and thereby boosts penetration. High penetration, in turn, makes a newspaper particularly valuable to retailers since it allows them to talk to the entire community through a single “megaphone.” A low-penetration paper is a far less compelling purchase for many advertisers and will eventually suffer in both ad rates and profits. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7375-7378

The term was appropriate some decades ago when the industry and regulators cooperated to conduct the business in cartel fashion. At that time, the combined ratio fluctuated rhythmically for two reasons, both related to lags. First, data from the past were analyzed and then used to set new “corrected” rates, which were subsequently put into effect by virtually all insurers. Second, the fact that almost all policies were then issued for a one-to three-year term—which meant that it took a considerable time for mispriced policies to expire—delayed the impact of new rates on revenues. These two lagged responses made combined ratios behave much like alternating current. Meanwhile, the absence of significant price competition guaranteed that industry profits, averaged out over the cycle, would be satisfactory. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7458-7463

Berkshire’s premium volume may drop to $150 million or so in 1990 (from a high of $1 billion in 1986), partly because our traditional business continues to shrink and partly because the contract under which we received 7% of the business of Fireman’s Fund expired last August. Whatever the size of the drop, it will not disturb us. We have no interest in writing insurance that carries a mathematical expectation of loss; we experience enough disappointments doing transactions we believe to carry an expectation of profit. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7480-7484

When losses exceed the retained amount, the reinsurer typically pays 95% of the excess up to its contractual limit, with the primary insurer paying the remainder. (By requiring the primary insurer to keep 5% of each layer, the reinsurer leaves him with a financial stake in each loss settlement and guards against his throwing away the reinsurer’s money.) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7487-7490

CAT covers are usually one-year policies that also provide for one automatic reinstatement, which requires a primary insurer whose coverage has been exhausted by a catastrophe to buy a second cover for the balance of the year in question by paying another premium. This provision protects the primary company from being “bare” for even a brief period after a first catastrophic event. The duration of “an event” is usually limited by contract to any span of 72 hours designated by the primary company. Under this definition, a wide-spread storm, causing damage for three days, will be classified as a single event if it arises from a single climatic cause. If the storm lasts four days, however, the primary company will file a claim carving out the 72 consecutive hours during which it suffered the greatest damage. Losses that occurred outside that period will be treated as arising from a separate event. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7490-7496

We will accept more reinsurance risk for our own account than any other company because of two factors: (1) by the standards of regulatory accounting, we have a net worth in our insurance companies of about $6 billion—the second highest amount in the United States; and (2) we simply don’t care what earnings we report quarterly, or even annually, just as long as the decisions leading to those earnings (or losses) were reached intelligently. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7512-7515

Through a truly rare blend of marketing and financial skills, Roberto has maximized both the growth of his product and the rewards that this growth brings to shareholders. Normally, the CEO of a consumer products company, drawing on his natural inclinations or experience, will cause either marketing or finance to dominate the business at the expense of the other discipline. With Roberto, the mesh of marketing and finance is perfect and the result is a shareholder’s dream. Of course, we should have started buying Coke much earlier, soon after Roberto and Don began running things. In fact, if I had been thinking straight I would have persuaded my grandfather to sell the grocery store back in 1936 and put all of the proceeds into Coca-Cola stock. I’ve learned my lesson: My response time to the next glaringly attractive idea will be slashed to well under 50 years. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7566-7572

During the year we sold a number of the low-coupon issues, which we originally bought at very large discounts. Many of these issues had approximately doubled in price since we purchased them and in addition had paid us 15%-17% annually, tax-free. Our prices upon sale were only slightly cheaper than typical high-grade tax-exempts then commanded. We have kept all of our high-coupon WPPSS issues. Some have been called for redemption in 1991 and 1992, and we expect the rest to be called in the early to mid-1990s. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7586-7590

In the first transaction, which took place in July, we purchased $600 million of The Gillette Co. preferred with an 8 3/4% dividend, a mandatory redemption in ten years, and the right to convert into common at $50 per share. We next purchased $358 million of USAir Group, Inc. preferred stock with mandatory redemption in ten years, a dividend of 9 1/4%, and the right to convert into common at $60 per share. Finally, late in the year we purchased $300 million of Champion International Corp. preferred with mandatory redemption in ten years, a 9 1/4% dividend, and the right to convert into common at $38 per share. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7594-7599

Unlike standard convertible preferred stocks, the issues we own are either non-salable or non-convertible for considerable periods of time and there is consequently no way we can gain from short-term price blips in the common stock. I have gone on the board of Gillette, but I am not on the board of USAir or Champion. (I thoroughly enjoy the boards I am on, but can’t handle any more.) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7599-7601

They in turn have demonstrated some confidence in us, insisting in each case that our preferreds have unrestricted voting rights on a fully-converted basis, an arrangement that is far from standard in corporate finance. In effect they are trusting us to be intelligent owners, thinking about tomorrow instead of today, just as we are trusting them to be intelligent managers, thinking about tomorrow as well as today. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7609-7612

Later, as the adrenalin of deal-makers surged, businesses began to be purchased at prices so high that all free cash flow necessarily had to be allocated to the payment of interest. That left nothing for the paydown of debt. In effect, a Scarlett O'Hara "I'll think about it tomorrow" position in respect to principal payments was taken by borrowers and accepted by a new breed of lender, the buyer of original-issue junk bonds. Debt now became something to be refinanced rather than repaid. The change brings to mind a New Yorker cartoon in which the grateful borrower rises to shake the hand of the bank's lending officer and gushes: "I don't know how I'll ever repay you." -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7677-7682

EBDIT—Earnings Before Depreciation, Interest and Taxes—as the test of a company's ability to pay interest. Using this sawed-off yardstick, the borrower ignored depreciation as an expense on the theory that it did not require a current cash outlay. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7683-7685

Such an attitude is clearly delusional. At 95% of American businesses, capital expenditures that over time roughly approximate depreciation are a necessity and are every bit as real an expense as labor or utility costs. Even a high school dropout knows that to finance a car he must have income that covers not only interest and operating expenses, but also realistically-calculated depreciation. He would be laughed out of the bank if he started talking about EBDIT. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7685-7688

So, stepping through the Looking Glass, promoters and their investment bankers proclaimed that EBDIT should now be measured against cash interest only, which meant that interest accruing on zero-coupon or PIK bonds could be ignored when the financial feasibility of a transaction was being assessed. This approach not only relegated depreciation expense to the let's-ignore-it corner, but gave similar treatment to what was usually a significant portion of interest expense. To their shame, many professional investment managers went along with this nonsense, though they usually were careful to do so only with clients' money, not their own. (Calling these managers "professionals" is actually too kind; they should be designated "promotees.") -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7694-7700

Some time ago Ken Galbraith, in his witty and insightful The Great Crash, coined a new economic term: "the bezzle," defined as the current amount of undiscovered embezzlement. This financial creature has a magical quality: The embezzlers are richer by the amount of the bezzle, while the embezzlees do not yet feel poorer. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7707-7710

Whenever an investment banker starts talking about EBDIT—or whenever someone creates a capital structure that does not allow all interest, both payable and accrued, to be comfortably met out of current cash flow net of ample capital expenditures—zip up your wallet. Turn the tables by suggesting that the promoter and his high-priced entourage accept zero-coupon fees, deferring their take until the zero-coupon bonds have been paid in full. See then how much enthusiasm for the deal endures. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7729-7732

The cost of the zero-coupon folly will not be borne solely by the direct participants. Certain savings and loan associations were heavy buyers of such bonds, using cash that came from FSLIC-insured deposits. Straining to show splendid earnings, these buyers recorded—but did not receive—ultra-high interest income on these issues. Many of these associations are now in major trouble. Had their loans to shaky credits worked, the owners of the associations would have pocketed the profits. In the many cases in which the loans will fail, the taxpayer will pick up the bill. To paraphrase Jackie Mason, at these associations it was the managers who should have been wearing the ski masks. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7738-7743

My first mistake, of course, was in buying control of Berkshire. Though I knew its business—textile manufacturing—to be unpromising, I was enticed to buy because the price looked cheap. Stock purchases of that kind had proved reasonably rewarding in my early years, though by the time Berkshire came along in 1965 I was becoming aware that the strategy was not ideal. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7746-7748

Shortly after purchasing Berkshire, I acquired a Baltimore department store, Hochschild Kohn, buying through a company called Diversified Retailing that later merged with Berkshire. I bought at a substantial discount from book value, the people were first-class, and the deal included some extras—unrecorded real estate values and a significant LIFO inventory cushion. How could I miss? So-o-o—three years later I was lucky to sell the business for about what I had paid. After ending our corporate marriage to Hochschild Kohn, I had memories like those of the husband in the country song, "My Wife Ran Away With My Best Friend and I Still Miss Him a -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7758-7762

The finding may seem unfair, but in both business and investments it is usually far more profitable to simply stick with the easy and obvious than it is to resolve the difficult. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7774-7775

My most surprising discovery: the overwhelming importance in business of an unseen force that we might call "the institutional imperative." In business school, I was given no hint of the imperative's existence and I did not intuitively understand it when I entered the business world. I thought then that decent, intelligent, and experienced managers would automatically make rational business decisions. But I learned over time that isn't so. Instead, rationality frequently wilts when the institutional imperative comes into play. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7778-7782

(1) As if governed by Newton's First Law of Motion, an institution will resist any change in its current direction; (2) Just as work expands to fill available time, corporate projects or acquisitions will materialize to soak up available funds; (3) Any business craving of the leader, however foolish, will be quickly supported by detailed rate-of-return and strategic studies prepared by his troops; and (4) The behavior of peer companies, whether they are expanding, acquiring, setting executive compensation or whatever, will be mindlessly imitated. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7782-7786

Some of my worst mistakes were not publicly visible. These were stock and business purchases whose virtues I understood and yet didn't make. It's no sin to miss a great opportunity outside one's area of competence. But I have passed on a couple of really big purchases that were served up to me on a platter and that I was fully capable of understanding. For Berkshire's shareholders, myself included, the cost of this thumb-sucking has been huge. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7794-7797

We hope in another 25 years to report on the mistakes of the first 50. If we are around in 2015 to do that, you can count on this section occupying many more pages than it does here. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7806-7807

I have attached as Appendix A on page 22 a previously unpublished satire on accounting practices written by Ben Graham in 1936. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 7979-7980

Two factors make this return even more remarkable. First, leverage did not produce it: Almost all our major facilities are owned, not leased, and such small debt as these operations have is basically offset by cash they hold. In fact, if the measurement was return on assets—a calculation that eliminates the effect of debt upon returns—our group would rank in Fortune's top ten. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8004-8007

Equally important, our return was not earned from industries, such as cigarettes or network television stations, possessing spectacular economics for all participating in them. Instead it came from a group of businesses operating in such prosaic fields as furniture retailing, candy, vacuum cleaners, and even steel warehousing. The explanation is clear: Our extraordinary returns flow from outstanding operating managers, not fortuitous industry economics. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8007-8010

The volatility I predict reflects the fact that we have become a large seller of insurance against truly major catastrophes ("super-cats"), which could for example be hurricanes, windstorms or earthquakes. The buyers of these policies are reinsurance companies that themselves are in the business of writing catastrophe coverage for primary insurers and that wish to "lay off," or rid themselves, of part of their exposure to catastrophes of special severity. Because the need for these buyers to collect on such a policy will only arise at times of extreme stress—perhaps even chaos—in the insurance business, they seek financially strong sellers. And here we have a major competitive advantage: In the industry, our strength is unmatched. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8152-8157

But in a plain- vanilla instance we might write a one-year, $10 million policy providing that the buyer, a reinsurer, would be paid that sum only if a catastrophe caused two results: (1) specific losses for the reinsurer above a threshold amount; and (2) aggregate losses for the insurance industry of, say, more than $5 billion. Under virtually all circumstances, loss levels that satisfy the second condition will also have caused the first to be met. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8158-8161

Therefore, our yearly combined ratio on this business will almost never fall in the industry range of 100—120, but will instead be close to either zero or 300%. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8163-8164

They may back away, for example, because they write gobs of primary property insurance that would deliver them dismal results at the very time they would be experiencing major losses on super- cat reinsurance. In addition, most corporate managements believe that their shareholders dislike volatility in results. We can take a different tack: Our business in primary property insurance is small and we believe that Berkshire shareholders, if properly informed, can handle unusual volatility in profits so long as the swings carry with them the prospect of superior long-term results. (Charlie and I always have preferred a lumpy 15% return to a smooth 12%.) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8165-8170

Because these funds are available to be invested, the typical property-casualty insurer can absorb losses and expenses that exceed premiums by 7% to 11% and still be able to break even on its business. Again, this calculation excludes the earnings the insurer realizes on net worth—that is, on the funds provided by shareholders. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8178-8180

insurance covering losses to crops from hail damage produces virtually no float at all. Premiums on this kind of business are paid to the insurer just prior to the time hailstorms are a threat, and if a farmer sustains a loss he will be paid almost immediately. Thus, a combined ratio of 100 for crop hail insurance produces no profit for the insurer. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8180-8183

malpractice insurance covering the potential liabilities of doctors, lawyers and accountants produces a very high amount of float compared to annual premium volume. The float materializes because claims are often brought long after the alleged wrongdoing takes place and because their payment may be still further delayed by lengthy litigation. The industry calls malpractice and certain other kinds of liability insurance "long- tail" business, in recognition of the extended period during which insurers get to hold large sums that in the end will go to claimants and their lawyers (and to the insurer's lawyers as well). -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8183-8187

We believe a better measure, however, to be a comparison of underwriting loss to float developed. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8196-8197

float figures are derived from the total of loss reserves, loss adjustment expense reserves and unearned premium reserves minus agents' balances, prepaid acquisition costs and deferred charges applicable to assumed reinsurance. At some insurers other items should enter into the calculation, but in our case these are unimportant and have been ignored. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8251-8253

The banking business is no favorite of ours. When assets are twenty times equity—a common ratio in this industry—mistakes that involve only a small portion of assets can destroy a major portion of equity. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8307-8308

Because leverage of 20:1 magnifies the effects of managerial strengths and weaknesses, we have no interest in purchasing shares of a poorly-managed bank at a "cheap" price. Instead, our only interest is in buying into well-managed banks at fair prices. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8311-8313

First, each pair is stronger than the sum of its parts because each partner understands, trusts and admires the other. Second, both managerial teams pay able people well, but abhor having a bigger head count than is needed. Third, both attack costs as vigorously when profits are at record levels as when they are under pressure. Finally, both stick with what they understand and let their abilities, not their egos, determine what they attempt. (Thomas J. Watson Sr. of IBM followed the same rule: "I'm no genius," he said. "I'm smart in spots—but I stay around those spots.") -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8315-8319

Wells Fargo currently earns well over $1 billion pre-tax annually after expensing more than $300 million for loan losses. If 10% of all $48 billion of the bank's loans—not just its real estate loans—were hit by problems in 1991, and these produced losses (including foregone interest) averaging 30% of principal, the company would roughly break even. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8334-8337

Nevertheless, fears of a California real estate disaster similar to that experienced in New England caused the price of Wells Fargo stock to fall almost 50% within a few months during 1990. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8339-8340

Similarly, at the Buffalo News we would cheer lower prices for newsprint—even though it would mean marking down the value of the large inventory of newsprint we always keep on hand—because we know we are going to be perpetually buying the product. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8345-8346

None of this means, however, that a business or stock is an intelligent purchase simply because it is unpopular; a contrarian approach is just as foolish as a follow-the-crowd strategy. What's required is thinking rather than polling. Unfortunately, Bertrand Russell's observation about life in general applies with unusual force in the financial world: "Most men would rather die than think. Many do." -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8351-8354

Therefore, we will look at any category of investment, so long as we understand the business we're buying into and believe that price and value may differ significantly. (Woody Allen, in another context, pointed out the advantage of open-mindedness: "I can't understand why more people aren't bi-sexual because it doubles your chances for a date on Saturday night.") -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8358-8361

Huge debt, we were told, would cause operating managers to focus their efforts as never before, much as a dagger mounted on the steering wheel of a car could be expected to make its driver proceed with intensified care. We'll acknowledge that such an attention-getter would produce a very alert driver. But another certain consequence would be a deadly—and unnecessary—accident if the car hit even the tiniest pothole or sliver of ice. The roads of business are riddled with potholes; a plan that requires dodging them all is a plan for disaster. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8367-8371

"Confronted with a challenge to distill the secret of sound investment into three words, we venture the motto, Margin of Safety." Forty-two years after reading that, I still think those are the right three words. The failure of investors to heed this simple message caused them staggering losses as the 1990s began. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8372-8374

One particularly egregious "kill- 'em-at-birth" case a few years back involved the purchase of a mature television station in Tampa, bought with so much debt that the interest on it exceeded the station's gross revenues. Even if you assume that all labor, programs and services were donated rather than purchased, this capital structure required revenues to explode—or else the station was doomed to go broke. (Many of the bonds that financed the purchase were sold to now-failed savings and loan associations; as a taxpayer, you are picking up the tab for this folly.) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8375-8379

As we said last year, we have never bought a new issue of a junk bond. (The only time to buy these is on a day with no "y" in it.) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8394-8395

The trouble this pricing has produced for all carriers illustrates an important truth: In a business selling a commodity-type product, it's impossible to be a lot smarter than your dumbest competitor. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8410-8412

Were I to die tomorrow, you could be sure of three things: (1) None of my stock would have to be sold; (2) Both a controlling shareholder and a manager with philosophies similar to mine would follow me; and (3) Berkshire's earnings would increase by $1 million annually, since Charlie would immediately sell our corporate jet, The Indefensible (ignoring my wish that it be buried with me). -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8461-8463

Writing down of Plant Account to Minus $1,000,000,000. Par value of common stock to be reduced to 1Â¢. Payment of all wages and salaries in option warrants. Inventories to be carried at $1. Preferred Stock to be replaced by non-interest bearing bonds redeemable at 50% discount. A $1,000,000,000 Contingency Reserve to be established. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8501-8503

It is now a well-recognized fact that many plants are in reality a liability rather than an asset, entailing not only depreciation charges, but taxes, maintenance, and other expenditures. Accordingly, the Board has decided to extend the write-down policy initiated in the 1935 report, and to mark down the Fixed Assets from $1,338,522,858.96 to a round Minus $1,000,000,000. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8512-8515

The goal of each investor should be to create a portfolio (in effect, a "company") that will deliver him or her the highest possible look-through earnings a decade or so from now. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8821-8823

An economic franchise arises from a product or service that: (1) is needed or desired; (2) is thought by its customers to have no close substitute and; (3) is not subject to price regulation. The existence of all three conditions will be demonstrated by a company's ability to regularly price its product or service aggressively and thereby to earn high rates of return on capital. Moreover, franchises can tolerate mis-management. Inept managers may diminish a franchise's profitability, but they cannot inflict mortal damage. In contrast, "a business" earns exceptional profits only if it is the low-cost operator or if supply of its product or service is tight. Tightness in supply usually does not last long. With superior management, a company may maintain its status as a low-cost operator for a much longer time, but even then unceasingly faces the possibility of competitive attack. And a business, unlike a franchise, can be killed by poor management. Until recently, media properties possessed the three characteristics of a franchise and consequently could both price aggressively and be managed loosely. Now, however, consumers looking for information and entertainment (their primary interest being the latter) enjoy greatly broadened choices as to where to find them. Unfortunately, demand can't expand in response to this new supply: 500 million American eyeballs and a 24-hour day are all that's available. The result is that competition has intensified, markets have fragmented, and the media industry has lost some—though far from all—of its franchise strength. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8834-8845

forever increase its earnings at 6% or so annually and would do so without the employment of additional capital, for the reason that depreciation charges would roughly match capital expenditures and working capital requirements would be minor. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8847-8849

akin to owning a perpetual annuity set to grow at 6% a year. Say, next, that a discount rate of 10% was used to determine the present value of that earnings stream. One could then calculate that it was appropriate to pay a whopping $25 million for a property with current after-tax earnings of $1 million. (This after-tax multiplier of 25 translates to a multiplier on pre-tax earnings of about 16.) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8850-8853

The obvious ones are that we've earned exceptional returns and had a good time in the process. Equally important, ownership of See's has taught us much about the evaluation of franchises. We've made significant money in certain common stocks because of the lessons we learned at See's. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8907-8909

Brown (which, by the way, has no connection to Brown Shoe of St. Louis) is the leading North American manufacturer of work shoes and boots, and it has a history of earning unusually fine margins on sales and assets. Shoes are a tough business—of the billion pairs purchased in the United States each year, about 85% are imported —and most manufacturers in the industry do poorly. The wide range of styles and sizes that producers offer causes inventories to be heavy; substantial capital is also tied up in receivables. In this kind of environment, only outstanding managers like Frank and the group developed by Mr. Heffernan can prosper. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8925-8929

A number of key managers are paid an annual salary of $7,800, to which is added a designated percentage of the profits of the company after these are reduced by a charge for capital employed. These managers therefore truly stand in the shoes of owners. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 8930-8932

If my universe of business possibilities was limited, say, to private companies in Omaha, I would, first, try to assess the long-term economic characteristics of each business; second, assess the quality of the people in charge of running it; and, third, try to buy into a few of the best operations at a sensible price. I certainly would not wish to own an equal part of every business in town. Why, then, should Berkshire take a different tack when dealing with the larger universe of public companies? And since finding great businesses and outstanding managers is so difficult, why should we discard proven products? (I was tempted to say "the real thing.") Our motto is: "If at first you do succeed, quit trying." -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9117-9122

"As time goes on, I get more and more convinced that the right method in investment is to put fairly large sums into enterprises which one thinks one knows something about and in the management of which one thoroughly believes. It is a mistake to think that one limits one's risk by spreading too much between enterprises about which one knows little and has no reason for special confidence. . . . One's knowledge and experience are definitely limited and there are seldom more than two or three enterprises at any given time in which I personally feel myself entitled to put full confidence." -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9123-9127

After we bought about 7 million shares, the price began to climb. In frustration, I stopped buying (a mistake that, thankfully, I did not repeat when Coca-Cola stock rose similarly during our purchase program). In an even sillier move, I surrendered to my distaste for holding small positions and sold the 7 million shares we owned. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9141-9143

On that occasion, we had a significant investment in a bank whose management was hell-bent on expansion. (Aren't they all?) When our bank wooed a smaller bank, its owner demanded a stock swap on a basis that valued the acquiree's net worth and earning power at over twice that of the acquirer's. Our management—visibly in heat—quickly capitulated. The owner of the acquiree then insisted on one other condition: "You must promise me," he said in effect, "that once our merger is done and I have become a major shareholder, you'll never again make a deal this dumb." -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9254-9258

However, it is clear that stocks cannot forever overperform their underlying businesses, -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9283-9283

Fanaticism," said Santyana, "consists of redoubling your effort when you've forgotten your aim.") -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9309-9310

(the leader being State Farm, which neither buys nor sells reinsurance). -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9504-9505

Rather than recording our super-cat premiums on a pro-rata basis over the life of a given policy, we defer recognition of revenue until a loss occurs or until the policy expires. We take this conservative approach because the likelihood of super-cats causing us losses is particularly great toward the end of the year. It is then that weather tends to kick up: Of the ten largest insured losses in U.S. history, nine occurred in the last half of the year. In addition, policies that are not triggered by a first event are unlikely, by their very terms, to cause us losses until late in the year. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9519-9523

"We select our marketable equity securities in much the way we would evaluate a business for acquisition in its entirety. We want the business to be one (a) that we can understand; (b) with favorable long-term prospects; (c) operated by honest and competent people; and (d) available at a very attractive price." We have seen cause to make only one change in this creed: Because of both market conditions and our size, we now substitute "an attractive price" for "a very attractive price." -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9635-9638

We view that as fuzzy thinking (in which, it must be confessed, I myself engaged some years ago). In our opinion, the two approaches are joined at the hip: Growth is always a component in the calculation of value, constituting a variable whose importance can range from negligible to enormous and whose impact can be negative as well as positive. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9641-9643

we think the very term "value investing" is redundant. What is "investing" if it is not the act of seeking value at least sufficient to justify the amount paid? Consciously paying more for a stock than its calculated value—in the hope that it can soon be sold for a still-higher price—should be labeled speculation (which is neither illegal, immoral nor—in our view—financially fattening). -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9643-9646

business growth, per se, tells us little about value. It's true that growth often has a positive impact on value, sometimes one of spectacular proportions. But such an effect is far from certain. For example, investors have regularly poured money into the domestic airline business to finance profitless (or worse) growth. For these investors, it would have been far better if Orville had failed to get off the ground at Kitty Hawk: The more the industry has grown, the worse the disaster for owners. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9651-9654

Growth benefits investors only when the business in point can invest at incremental returns that are enticing—in other words, only when each dollar used to finance the growth creates over a dollar of long-term market value. In the case of a low-return business requiring incremental funds, growth hurts the investor. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9654-9656

John Burr Williams set forth the equation for value, which we condense here: The value of any stock, bond or business today is determined by the cash inflows and outflows—discounted at an appropriate interest rate—that can be expected to occur during the remaining life of the asset. Note that the formula is the same for stocks as for bonds. Even so, there is an important, and difficult to deal with, difference between the two: A bond has a coupon and maturity date that define future cash flows; but in the case of equities, the investment analyst must himself estimate the future "coupons." Furthermore, the quality of management affects the bond coupon only rarely—chiefly when management is so inept or dishonest that payment of interest is suspended. In contrast, the ability of management can dramatically affect the equity "coupons." -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9657-9663

Leaving the question of price aside, the best business to own is one that over an extended period can employ large amounts of incremental capital at very high rates of return. The worst business to own is one that must, or will, do the opposite—that is, consistently employ ever-greater amounts of capital at very low rates of return. Unfortunately, the first type of business is very hard to find: Most high-return businesses need relatively little capital. Shareholders of such a business usually will benefit if it pays out most of its earnings in dividends or makes significant stock repurchases. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9667-9671

What counts for most people in investing is not how much they know, but rather how realistically they define what they don't know. An investor needs to do very few things right as long as he or she avoids big mistakes. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9675-9676

If we calculate the value of a common stock to be only slightly higher than its price, we're not interested in buying. We believe this margin-of-safety principle, so strongly emphasized by Ben Graham, to be the cornerstone of investment success. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9677-9678

Despite the success we experienced with our Gillette preferred, which converted to common stock in 1991, and despite our reasonable results with other negotiated purchases of preferreds, our overall performance with such purchases has been inferior to that we have achieved with purchases made in the secondary market. This is actually the result we expected. It corresponds with our belief that an intelligent investor in common stocks will do better in the secondary market than he will do buying new issues. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9704-9708

The secondary market, which is periodically ruled by mass folly, is constantly setting a "clearing" price. No matter how foolish that price may be, it's what counts for the holder of a stock or bond who needs or wishes to sell, of whom there are always going to be a few at any moment. In many instances, shares worth xin business value have sold in the market for 1/2x or less. The new-issue market, on the other hand, is ruled by controlling stockholders and corporations, who can usually select the timing of offerings or, if the market looks unfavorable, can avoid an offering altogether. Understandably, these sellers are not going to offer any bargains, either by way of a public offering or in a negotiated transaction: It's rare you'll find x for1/2x here. Indeed, in the case of common-stock offerings, selling shareholders are often motivated to unload only when they feel the market is overpaying. (These sellers, of course, would state that proposition somewhat differently, averring instead that they simply resist selling when the market is underpaying for their goods.) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9708-9716

the case of our commitment to USAir, industry economics had soured before the ink dried on our check. As I've previously mentioned, it was I who happily jumped into the pool; no one pushed me. Yes, I knew the industry would be ruggedly competitive, but I did not expect its leaders to engage in prolonged kamikaze behavior. In the last two years, airline companies have acted as if they are members of a competitive tontine, which they wish to bring to its conclusion as rapidly as possible. Amidst this turmoil, Seth Schofield, CEO of USAir, has done a truly extraordinary job in repositioning the airline. He was particularly courageous in accepting a strike last fall that, had it been lengthy, might well have bankrupted the company. Capitulating to the striking union, however, would have been equally disastrous: The company was burdened with wage costs and work rules that were considerably more onerous than those encumbering its major competitors, and it was clear that over time any high-cost producer faced extinction. Happily -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9721-9728

competitively-beset business such as USAir requires far more managerial skill than does a business with fine economics. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9729-9730

Another major accounting change, whose implementation is required by January 1, 1993, mandates that businesses recognize their present-value liability for post-retirement health benefits. Though GAAP has previously required recognition of pensions to be paid in the future, it has illogically ignored the costs that companies will then have to bear for health benefits. The new rule will force many companies to record a huge balance-sheet liability (and a consequent reduction in net worth) and also henceforth to recognize substantially higher costs when they are calculating annual profits. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9745-9748

In health-care, open-ended promises have created open-ended liabilities that in a few cases loom so large as to threaten the global competitiveness of major American industries. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9760-9761

part of the reason for this reckless behavior was that accounting rules did not, for so long, require the booking of post-retirement health costs as they were incurred. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9761-9762

"How many legs does a dog have if you call his tail a leg?" The answer: "Four, because calling a tail a leg does not make it a leg." -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9766-9767

Right now, accounting abounds with imprecision. After all, no manager or auditor knows how long a 747 is going to last, which means he also does not know what the yearly depreciation charge for the plane should be. No one knows with any certainty what a bank's annual loan loss charge ought to be. And the estimates of losses that property-casualty companies make are notoriously inaccurate. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9782-9785

Rather, these costs should be estimated by honest and experienced people and then recorded. When you get right down to it, what other item of major but hard-to-precisely-calculate cost—other, that is, than stock options—does the accounting profession say should be ignored in the calculation of earnings? -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9786-9788

Additionally, the lobbying that executives engage in may have an unfortunate by-product: In my opinion, the business elite risks losing its credibility on issues of significance to society—about which it may have much of value to say—when it advocates the incredible on issues of significance to itself. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9797-9799

This time around, Mrs. B graciously offered to sign a non-compete agreement—and I, having been incautious on this point when she was 89, snapped at the deal. Mrs. B belongs in the Guinness Book of World Records on many counts. Signing a non-compete at 99 merely adds one more. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9817-9819

We're admirers of the Wal-Mart, Nucor, Dover, GEICO, Golden West Financial and Price Co. models. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9840-9840

So we promptly jumped at the chance last year to acquire Dexter Shoe of Dexter, Maine, which manufactures popular-priced men's and women's shoes. Dexter, I can assure you, needs no fixing: It is one of the best-managed companies Charlie and I have seen in our business lifetimes. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9945-9947

At Berkshire, we have no view of the future that dictates what businesses or industries we will enter. Indeed, we think it's usually poison for a corporate giant's shareholders if it embarks upon new ventures pursuant to some grand vision. We prefer instead to focus on the economic characteristics of businesses that we wish to own and the personal characteristics of managers with whom we wish to associate—and then to hope we get lucky in finding the two in combination. At Dexter, we did. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 9958-9961

Directly and indirectly, Berkshire's 1993 federal income tax payments will be about 1/2 of 1% of the total paid last year by all American corporations. Speaking for our own shares, Charlie and I have absolutely no complaint about these taxes. We know we work in a market-based economy that rewards our efforts far more bountifully than it does the efforts of others whose output is of equal or greater benefit to society. Taxation should, and does, partially redress this inequity. But we still remain extraordinarily well-treated. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10120-10124

As interest rates have fallen, however, the value of float has substantially declined. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10153-10154

We calculate our float—which we generate in exceptional amounts relative to our premium volume—by adding loss reserves, loss adjustment reserves and unearned premium reserves and then subtracting agent's balances, prepaid acquisition costs and deferred charges applicable to assumed reinsurance. Our cost of float is determined by our underwriting loss or profit. In -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10161-10164

In most lines of insurance, huge resources aren't that important: An insurer can diversify the risks it writes and, if necessary, can lay off risks to reduce concentration in its portfolio. That isn't possible in the super-cat business. So these competitors are forced into offering far smaller limits than those we can provide. Were they bolder, they would run the risk that a mega-catastrophe—or a confluence of smaller catastrophes—would wipe them out. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10237-10240

A parent company that owns a subsidiary with superb long-term economics is not likely to sell that entity regardless of price. "Why," the CEO would ask, "should I part with my crown jewel?" Yet that same CEO, when it comes to running his personal investment portfolio, will offhandedly—and even impetuously—move from business to business when presented with no more than superficial arguments by his broker for doing so. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10284-10287

In their hunger for a single statistic to measure risk, however, they forget a fundamental principle: It is better to be approximately right than precisely wrong. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10312-10313

In fact, the true investor welcomes volatility. Ben Graham explained why in Chapter 8 of The Intelligent Investor. There he introduced "Mr. Market," an obliging fellow who shows up every day to either buy from you or sell to you, whichever you wish. The more manic-depressive this chap is, the greater the opportunities available to the investor. That's true because a wildly fluctuating market means that irrationally low prices will periodically be attached to solid businesses. It is impossible to see how the availability of such prices can be thought of as increasing the hazards for an investor who is totally free to either ignore the market or exploit its folly. In assessing risk, a beta purist will disdain examining what a company produces, what its competitors are doing, or how much borrowed money the business employs. He may even prefer not to know the company's name. What he treasures is the price history of its stock. In contrast, we'll happily forgo knowing the price history and instead will seek whatever information will further our understanding of the company's business. After we buy a stock, consequently, we would not be disturbed if markets closed for a year or two. We don't need a daily quote on our 100% position in See's or H. H. Brown to validate our well-being. Why, then, should we need a quote on our 7% interest in Coke? In our opinion, the real risk that an investor must assess is whether his aggregate after-tax receipts from an investment (including those he receives on sale) will, over his prospective holding period, give him at least as much purchasing power as he had to begin with, plus a modest rate of interest on that initial stake. Though this risk cannot be calculated with engineering precision, it can in some cases be judged with a degree of accuracy that is useful. The primary factors bearing upon this evaluation are: 1) The certainty with which the long-term economic characteristics of the business can be evaluated; 2) The certainty with which management can be evaluated, both as to its ability to realize the full potential of the business and to wisely employ its cash flows; 3) The certainty with which management can be counted on to channel the rewards from the business to the shareholders rather than to itself; 4) The purchase price of the business; 5) The levels of taxation and inflation that will be experienced and that will determine the degree by which an investor's purchasing-power return is reduced from his gross return. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10317-10336

The might of their brand names, the attributes of their products, and the strength of their distribution systems give them an enormous competitive advantage, setting up a protective moat around their economic castles. The average company, in contrast, does battle daily without any such means of protection. As Peter Lynch says, stocks of companies selling commodity-like products should come with a warning label: "Competition may prove hazardous to human wealth." -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10344-10347

As Peter Lynch says, stocks of companies selling commodity-like products should come with a warning label: "Competition may prove hazardous to human wealth." -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10346-10347

The first, and by far most common, board situation is one in which a corporation has no controlling shareholder. In that case, I believe directors should behave as if there is a single absentee owner, whose long-term interest they should try to further in all proper ways. Unfortunately, "long-term" gives directors a lot of wiggle room. If they lack either integrity or the ability to think independently, directors can do great violence to shareholders while still claiming to be acting in their long-term interest. But assume the board is functioning well and must deal with a management that is mediocre or worse. Directors then have the responsibility for changing that management, just as an intelligent owner would do if he were present. And if able but greedy managers over-reach and try to dip too deeply into the shareholders' pockets, directors must slap their hands. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10385-10391

In this plain-vanilla case, a director who sees something he doesn't like should attempt to persuade the other directors of his views. If he is successful, the board will have the muscle to make the appropriate change. Suppose, though, that the unhappy director can't get other directors to agree with him. He should then feel free to make his views known to the absentee owners. Directors seldom do that, of course. The temperament of many directors would in fact be incompatible with critical behavior of that sort. But I see nothing improper in such actions, assuming the issues are serious. Naturally, the complaining director can expect a vigorous rebuttal from the unpersuaded directors, a prospect that should discourage the dissenter from pursuing trivial or non-rational causes. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10391-10396

For the boards just discussed, I believe the directors ought to be relatively few in number—say, ten or less—and ought to come mostly from the outside. The outside board members should establish standards for the CEO's performance and should also periodically meet, without his being present, to evaluate his performance against those standards. The requisites for board membership should be business savvy, interest in the job, and owner-orientation. Too often, directors are selected simply because they are prominent or add diversity to the board. That practice is a mistake. Furthermore, mistakes in selecting directors are particularly serious because appointments are so hard to undo: The pleasant but vacuous director need never worry about job security. The second case is that existing at Berkshire, where the controlling owner is also the manager. At some companies, this arrangement is facilitated by the existence of two classes of stock endowed with disproportionate voting power. In these situations, it's obvious that the board does not act as an agent between owners and management and that the directors cannot effect change except through persuasion. Therefore, if the owner/manager is mediocre or worse—or is over-reaching—there is little a director can do about it except object. If the directors having no connections to the owner/manager make a unified argument, it may well have some effect. More likely it will not. If change does not come, and the matter is sufficiently serious, the outside directors should resign. Their resignation will signal their doubts about management, and it will emphasize that no outsider is in a position to correct the owner/manager's shortcomings. The third governance case occurs when there is a controlling owner who is not involved in management. This case, examples of which are Hershey Foods and Dow Jones, puts the outside directors in a potentially useful position. If they become unhappy with either the competence or integrity of the manager, they can go directly to the owner (who may also be on the board) and report their dissatisfaction. This situation is ideal for an outside director, since he need make his case only to a single, presumably interested owner, who can forthwith effect change if the argument is persuasive. Even so, the dissatisfied director has only that single course of action. If he remains unsatisfied about a critical matter, he has no choice but to resign. Logically, the third case should be the most effective in insuring first-class management. In the second case the owner is not going to fire himself, and in the first case, directors often find it very difficult to deal with mediocrity or mild over-reaching. Unless the unhappy directors can win over a majority of the board—an awkward social and logistical task, particularly if management's behavior is merely odious, not egregious—their hands are effectively tied. In practice, directors trapped in situations of this kind usually convince themselves that by staying around they can do at least some good. Meanwhile, management proceeds -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10396-10418

Frank has known Harold Alfond and Peter Lunder for decades, and shortly after our purchase of H. H. Brown, told me what a wonderful operation they managed. He encouraged us to get together and in due course we made a deal. Frank told Harold and Peter that Berkshire would provide an ideal corporate "home" for Dexter, and that assurance undoubtedly contributed to their decision to join with -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10492-10495

(As Charlie regularly reminds me, "If something is not worth doing at all, it's not worth doing well.") -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10529-10529

Ted Williams, in The Story of My Life, explains why: "My argument is, to be a good hitter, you've got to get a good ball to hit. It's the first rule in the book. If I have to bite at stuff that is out of my happy zone, I'm not a .344 hitter. I might only be a .250 hitter." Charlie and I agree and will try to wait for opportunities that are well within our own "happy zone." -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10531-10534

But, surprise—none of these blockbuster events made the slightest dent in Ben Graham's investment principles. Nor did they render unsound the negotiated purchases of fine businesses at sensible prices. Imagine the cost to us, then, if we had let a fear of unknowns cause us to defer or alter the deployment of capital. Indeed, we have usually made our best purchases when apprehensions about some macro event were at a peak. Fear is the foe of the faddist, but the friend of the fundamentalist. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10537-10540

Casey Stengel described managing a baseball team as "getting paid for home runs other fellows hit." That's my formula at Berkshire, also. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10555-10556

And, at Wells Fargo, a $53 billion bank, our 13% ownership translates into a $7 billion "Berkshire Bank" that earned about $100 million during 1994. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10560-10561

We define intrinsic value as the discounted value of the cash that can be taken out of a business during its remaining life. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10575-10576

Anyone calculating intrinsic value necessarily comes up with a highly subjective figure that will change both as estimates of future cash flows are revised and as interest rates move. Despite its fuzziness, however, intrinsic value is all-important and is the only logical way to evaluate the relative attractiveness of investments and businesses. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10576-10578

For this exercise, we will ignore the important non-economic benefits of an education and focus strictly on its economic value. First, we must estimate the earnings that the graduate will receive over his lifetime and subtract from that figure an estimate of what he would have earned had he lacked his education. That gives us an excess earnings figure, which must then be discounted, at an appropriate interest rate, back to graduation day. The dollar result equals the intrinsic economic value of the education. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10580-10584

Scott Fetzer's return on equity would have ranked it first on the Fortune 500, well ahead of number two. Indeed, Scott Fetzer's return on equity was double that of the company ranking tenth. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10634-10635

Ben Graham taught me 45 years ago that in investing it is not necessary to do extraordinary things to get extraordinary results. In later life, I have been surprised to find that this statement holds true in business management as well. What a manager must do is handle the basics well and not get diverted. That's precisely Ralph's formula. He establishes the right goals and never forgets what he set out to do. On the personal side, Ralph is a joy to work with. He's forthright about problems and is self-confident without being self-important. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10675-10678

The product of this money's-not-free approach is definitely visible at Scott Fetzer. If Ralph can employ incremental funds at good returns, it pays him to do so: His bonus increases when earnings on additional capital exceed a meaningful hurdle charge. But our bonus calculation is symmetrical: If incremental investment yields sub-standard returns, the shortfall is costly to Ralph as well as to Berkshire. The consequence of this two-way arrangement is that it pays Ralph—and pays him well—to send to Omaha any cash he can't advantageously use in his business. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10721-10725

Indeed, the combination of a ten-year option, a low dividend payout, and compound interest can provide lush gains to a manager who has done no more than tread water in his job. A cynic might even note that when payments to owners are held down, the profit to the option-holding manager increases. I have yet to see this vital point spelled out in a proxy statement asking shareholders to approve an option plan. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10729-10731

Ralph Schey was worked out in about five minutes, immediately upon our purchase of Scott Fetzer and without the "help" of lawyers or compensation consultants. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10732-10733

An insurance business is profitable over time if its cost of float is less than the cost the company would otherwise incur to obtain funds. But the business has a negative value if the cost of its float is higher than market rates for money. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10886-10887

For the table, we have compiled our float—which we generate in exceptional amounts relative to our premium volume—by adding loss reserves, loss adjustment reserves, funds held under reinsurance assumed and unearned premium reserves and then subtracting agents' balances, prepaid acquisition costs, prepaid taxes and deferred charges applicable to assumed reinsurance. Our cost of float is determined by our underwriting loss or profit. In those years when we have had an underwriting profit, such as the last two, our cost of float has been negative, and we have determined our insurance earnings by adding underwriting profit to float income. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 10888-10893

We purchased National Indemnity in 1967, See's in 1972, Buffalo News in 1977, Nebraska Furniture Mart in 1983, and Scott Fetzer in 1986 because those are the years they became available and because we thought the prices they carried were acceptable. In each case, we pondered what the business was likely to do, not what the Dow, the Fed, or the economy might do. If we see this approach as making sense in the purchase of businesses in their entirety, why should we change tack when we are purchasing small pieces of wonderful businesses in the stock market? -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 11027-11031

In 1951, for example, GEICO shares comprised 70% of my personal portfolio and GEICO was also the first stock I sold—I was then 20—as a security salesman (the sale was 100 shares to my Aunt Alice who, bless her, would have bought anything I suggested). Twenty-five years later, Berkshire purchased a major stake in GEICO at the time it was threatened with insolvency. In another instance, that of the Washington Post, about half of my initial investment funds came from delivering the paper in the 1940's. Three decades later Berkshire purchased a large position in the company two years after it went public. As for Coca-Cola, my first business venture—this was in the 1930's—was buying a six-pack of Coke for 25 cents and selling each bottle for 5 cents. It took only fifty years before I finally got it: The real money was in the syrup. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 11036-11041

I first purchased stock in IDS in 1953 when it was growing rapidly and selling at a price-earnings ratio of only 3. (There was a lot of low-hanging fruit in those days.) I even produced a long report—do I ever write a short one?—on the company that I sold for $1 through an ad in the Wall Street Journal. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 11046-11048

Our $358 million purchase of USAir preferred stock, on which the dividend was suspended in September. In the 1990 Annual Report I correctly described this deal as an "unforced error," meaning that I was neither pushed into the investment nor misled by anyone when making it. Rather, this was a case of sloppy analysis, a lapse that may have been caused by the fact that we were buying a senior security or by hubris. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 11057-11060

problems that would inevitably beset a carrier whose costs were both high and extremely difficult to lower. In earlier years, these life-threatening costs posed few problems. Airlines were then protected from competition by regulation, and carriers could absorb high costs because they could pass them along by way of fares that were also high. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 11061-11063

The day of reckoning for these airlines could be delayed by infusions of capital (such as ours into USAir), but eventually a fundamental rule of economics prevailed: In an unregulated commodity business, a company must lower its costs to competitive levels or face extinction. This principle should have been obvious to your Chairman, but I missed it. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 11067-11069

In a general way, we knew then what we hoped to accomplish but had no idea what specific opportunities might make it possible. Today we remain similarly unstructured: Over time, we expect to improve the figures in both columns but have no road map to tell us how that will come about. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 11164-11166

First, our operating managers are outstanding and, in most cases, have an unusually strong attachment to Berkshire. Second, Charlie and I have had considerable experience in allocating capital and try to go at that job rationally and objectively. The giant disadvantage we face is size: In the early years, we needed only good ideas, but now we need good big ideas. Unfortunately, the difficulty of finding these grows in direct proportion to our financial success, a problem that increasingly erodes our strengths. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 11166-11170

We believe most deals do damage to the shareholders of the acquiring company. Too often, the words from HMS Pinafore apply: "Things are seldom what they seem, skim milk masquerades as cream." Specifically, sellers and their representatives invariably present financial projections having more entertainment value than educational value. In the production of rosy scenarios, Wall Street can hold its own against Washington. In any case, why potential buyers even look at projections prepared by sellers baffles me. Charlie and I never give them a glance, but instead keep in mind the story of the man with an ailing horse. Visiting the vet, he said: "Can you help me? Sometimes my horse walks just fine and sometimes he limps." The vet's reply was pointed: “No problem—when he’s walking fine, sell him.” In the world of mergers and acquisitions, that horse would be peddled as Secretariat. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 11173-11179

we face the inherent problem that the seller of a business practically always knows far more about it than the buyer and also picks the time of sale—a time when the business is likely to be walking “just fine.” -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 11180-11181

Even so, we do have a few advantages, perhaps the greatest being that we don’t have a strategic plan. Thus we feel no need to proceed in an ordained direction (a course leading almost invariably to silly purchase prices) but can instead simply decide what makes sense for our owners. In doing that, we always mentally compare any move we are contemplating with dozens of other opportunities open to us, including the purchase of small pieces of the best businesses in the world via the stock market. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 11181-11185

Peter Drucker got to the heart of things: “I will tell you a secret: Dealmaking beats working. Dealmaking is exciting and fun, and working is grubby. Running anything is primarily an enormous amount of grubby detail work . . . dealmaking is romantic, sexy. That’s why you have deals that make no sense.” -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 11186-11189

Retailing is a tough business. During my investment career, I have watched a large number of retailers enjoy terrific growth and superb returns on equity for a period, and then suddenly nosedive, often all the way into bankruptcy. This shooting-star phenomenon is far more common in retailing than it is in manufacturing or service businesses. In part, this is because a retailer must stay smart, day after day. Your competitor is always copying and then topping whatever you do. Shoppers are meanwhile beckoned in every conceivable way to try a stream of new merchants. In retailing, to coast is to fail. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 11240-11244

In contrast to this have-to-be-smart-every-day business, there is what I call the have-to-be-smart-once business. For example, if you were smart enough to buy a network TV station very early in the game, you could put in a shiftless and backward nephew to run things, and the business would still do well for decades. You’d do far better, of course, if you put in Tom Murphy, but you could stay comfortably in the black without him. For a retailer, hiring that nephew would be an express ticket to bankruptcy. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 11244-11247

Davy has been one of my heroes for the 45 years I’ve known him, and he’s never let me down. You should understand that Berkshire would not be where it is today if Davy had not been so generous with his time on a cold Saturday in 1951. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 11303-11305

An insurance business is profitable over time if its cost of float is less than the cost the company would otherwise incur to obtain funds. But the business has a negative value if the cost of its float is higher than market rates for money. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 11311-11313

Any company’s level of profitability is determined by three items: (1) what its assets earn; (2) what its liabilities cost; and (3) its utilization of “leverage”—that is, the degree to which its assets are funded by liabilities rather than by equity. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 11379-11381

Any company’s level of profitability is determined by three items: (1) what its assets earn; (2) what its liabilities cost; and (3) its utilization of “leverage”—that is, the degree to which its assets are funded by liabilities rather than by equity. Over the years, we have done well on Point 1, having produced high returns on our assets. But we have also benefitted greatly—to a degree that is not generally well-understood—because our liabilities have cost us very little. An important reason for this low cost is that we have obtained float on very advantageous terms. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 11379-11383

Ajit Jain is the guiding genius of our super-cat business and writes important non-cat business as well. In insurance, the term “catastrophe” is applied to an event, such as a hurricane or earthquake, that causes a great many insured losses. The other deals Ajit enters into usually cover only a single large loss. A simplified description of three transactions from last year will illustrate both what I mean and Ajit’s versatility. We insured: (1) The life of Mike Tyson for a sum that is large initially and that, fight-by-fight, gradually declines to zero over the next few years; (2) Lloyd’s against more than 225 of its “names” dying during the year; and (3) The launch, and a year of orbit, of two Chinese satellites. Happily, both satellites are orbiting, the Lloyd’s folk avoided abnormal mortality, and if Mike Tyson looked any healthier, no one would get in the ring with him. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 11402-11408

A bad reinsurance contract is like hell: easy to enter and impossible to exit. I actively participated in those early reinsurance decisions, and Berkshire paid a heavy tuition for my education in the business. Unfortunately, reinsurance students can’t attend school on scholarship. GEICO, incidentally, suffered a similar, disastrous experience in the early 1980’s, when it plunged enthusiastically into the writing of reinsurance and large risks. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 11426-11429

Our other two preferreds have been disappointing, though the Salomon preferred has modestly outperformed the fixed-income securities for which it was a substitute. However, the amount of management time Charlie and I have devoted to this holding has been vastly greater than its economic significance to Berkshire. Certainly I never dreamed I would take a new job at age 60—Salomon interim chairman, that is—because of an earlier purchase of a fixed-income security. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 11641-11645

The first column lists our per-share ownership of investments (including cash and equivalents) and the second column shows our per-share earnings from Berkshire’s operating businesses before taxes and purchase-accounting adjustments but after all interest and corporate overhead expenses. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 11804-11806

FlightSafety International, the world’s leader in the training of pilots—was far larger, at about $1.5 billion, -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 11865-11866

Even if perfection in assessing risks is unattainable, insurers can underwrite sensibly. After all, you need not know a man’s precise age to know that he is old enough to vote nor know his exact weight to recognize his need to diet. In insurance, it is essential to remember that virtually all surprises are unpleasant, and with that in mind we try to price our super-cat exposures so that about 90% of total premiums end up being eventually paid out in losses and expenses. Over time, we will find out how smart our pricing has been, but that will not be quickly. The super-cat business is just like the investment business in that it often takes a long time to find out whether you knew what you were doing. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 12015-12020

The company's competitive strength flows directly from its position as a low-cost operator. Low costs permit low prices, and low prices attract and retain good policyholders. The final segment of a virtuous circle is drawn when policyholders recommend us to their friends. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 12035-12037

Goals should be (1) tailored to the economics of the specific operating business; (2) simple in character so that the degree to which they are being realized can be easily measured; and (3) directly related to the daily activities of plan participants. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 12056-12057

Goals should be (1) tailored to the economics of the specific operating business; (2) simple in character so that the degree to which they are being realized can be easily measured; and (3) directly related to the daily activities of plan participants. As a corollary, we shun "lottery ticket" arrangements, such as options on Berkshire shares, whose ultimate value—which could range from zero to huge—is totally out of the control of the person whose behavior we would like to affect. In our view, a system that produces quixotic payoffs will not only be wasteful for owners but may actually discourage the focused behavior we value in managers. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 12056-12060

Despite the operation's new status as the only direct-seller of encyclopedias in the country (Encyclopedia Britannica exited the field last year), its unit volume fell. Additionally, World Book spent heavily on a new CD-ROM product that began to take in revenues only in early 1997, when it was launched in association with IBM. In the face of these factors, earnings would have evaporated had World Book not revamped distribution methods and cut overhead at headquarters, thereby dramatically reducing its fixed costs. Overall, the company has gone a long way toward assuring its long-term viability in both the print and electronic marketplaces. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 12158-12163

Helzberg's suffered a material decline in earnings. Its expense levels had been geared to a sizable increase in same-store sales, consistent with the gains achieved in recent years. When sales were instead flat, profit margins fell. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 12163-12165

Inactivity strikes us as intelligent behavior. Neither we nor most business managers would dream of feverishly trading highly-profitable subsidiaries because a small move in the Federal Reserve's discount rate was predicted or because some Wall Street pundit had reversed his views on the market. Why, then, should we behave differently with our minority positions in wonderful businesses? -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 12237-12240

Companies such as Coca-Cola and Gillette might well be labeled "The Inevitables." Forecasters may differ a bit in their predictions of exactly how much soft drink or shaving-equipment business these companies will be doing in ten or twenty years. Nor is our talk of inevitability meant to play down the vital work that these companies must continue to carry out, in such areas as manufacturing, distribution, packaging and product innovation. In the end, however, no sensible observer—not even these companies' most vigorous competitors, assuming they are assessing the matter honestly—questions that Coke and Gillette will dominate their fields worldwide for an investment lifetime. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 12269-12273

You can, of course, pay too much for even the best of businesses. The overpayment risk surfaces periodically and, in our opinion, may now be quite high for the purchasers of virtually all stocks, The Inevitables included. Investors making purchases in an overheated market need to recognize that it may often take an extended period for the value of even an outstanding company to catch up with the price they paid. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 12282-12285

Most investors, both institutional and individual, will find that the best way to own common stocks is through an index fund that charges minimal fees. Those following this path are sure to beat the net results (after fees and expenses) delivered by the great majority of investment professionals. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 12292-12294

You don't have to be an expert on every company, or even many. You only have to be able to evaluate companies within your circle of competence. The size of that circle is not very important; knowing its boundaries, however, is vital. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 12296-12297

purchase, at a rational price, a part interest in an easily-understandable business whose earnings are virtually certain to be materially higher five, ten and twenty years from now. Over time, you will find only a few companies that meet these standards—so when you see one that qualifies, you should buy a meaningful amount of stock. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 12301-12303

When Richard Branson, the wealthy owner of Virgin Atlantic Airways, was asked how to become a millionaire, he had a quick answer: "There's really nothing to it. Start as a billionaire and then buy an airline." -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 12311-12313

Making our investment, we wrote into the preferred contract a somewhat unusual provision stipulating that "penalty dividends"—to run five percentage points over the prime rate—would be accrued on any arrearages. This meant that when our 9.25% dividend was omitted for two years, the unpaid amounts compounded at rates ranging between 13.25% and 14%. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 12325-12328

To blunt the enthusiasm that brokers normally have for pushing new issues—because that's where the money is—we arranged for our offering to carry a commission of only 1.5%, the lowest payoff that we have ever seen in a common stock underwriting. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 12351-12353

Given that background, it won't surprise you to learn that we again went to Terry when we decided late in the year to sell an issue of Berkshire notes that can be exchanged for a portion of the Salomon shares that we hold. In this instance, once again, Salomon did an absolutely first-class job, selling $500 million principal amount of five-year notes for $447.1 million. Each $1,000 note is exchangeable into 17.65 shares and is callable in three years at accreted value. Counting the original issue discount and a 1% coupon, the securities will provide a yield of 3% to maturity for holders who do not exchange them for Salomon stock. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 12362-12366

In a bull market, one must avoid the error of the preening duck that quacks boastfully after a torrential rainstorm, thinking that its paddling skills have caused it to rise in the world. A right-thinking duck would instead compare its position after the downpour to that of the other ducks on the pond. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 12434-12436

It’s no wonder that my annual results in the 1950s were better by nearly thirty percentage points than my annual gains in any subsequent decade. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 12481-12482

In recent years, bullion inventories have fallen materially, and last summer Charlie and I concluded that a higher price would be needed to establish equilibrium between supply and demand. Inflation expectations, it should be noted, play no part in our calculation of silver’s value. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 12510-12512

Our super-cat business was developed from scratch by Ajit Jain, who has contributed to Berkshire’s success in a variety of other ways as well. Ajit possesses both the discipline to walk away from business that is inadequately priced and the imagination to then find other opportunities. Quite simply, he is one of Berkshire’s major assets. Ajit would have been a star in whatever career he chose; fortunately for us, he enjoys insurance. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 12661-12664

Our goal is to pass on most of the benefits of our low-cost operation to our customers, holding ourselves to about 4% in underwriting profit. With that in mind, we reduced our average rates a bit during 1997 and may well cut them again this year. Our rate changes varied, of course, depending on the policyholder and where he lives; we strive to charge a rate that properly reflects the loss expectancy of each driver. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 12682-12685

In none of Berkshire’s subsidiaries do we relate compensation to our stock price, which our associates cannot affect in any meaningful way. Instead, we tie bonuses to each unit’s business performance, which is the direct product of the unit’s people. When that performance is terrific—as it has been at GEICO—there is nothing Charlie and I enjoy more than writing a big check. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 12693-12696

Here’s where I got lucky. During that month of decision, I played golf at Prouts Neck, Maine with Frank Olson, CEO of Hertz. Frank is a brilliant manager, with intimate knowledge of the card business. So from the first tee on I was quizzing him about the industry. By the time we reached the second green, Frank had convinced me that Amex’s corporate card was a terrific franchise, and I had decided not to sell. On the back nine I turned buyer, and in a few months Berkshire owned 10% of the company. We now have a $3 billion gain in our Amex shares, and I naturally feel very grateful to Frank. But George Gillespie, our mutual friend, says that I am confused about where my gratitude should go. After all, he points out, it was he who arranged the game and assigned me to Frank’s foursome. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 12993-12998

The federal income taxes that Berkshire and General Re have paid, or will soon pay, in respect to 1998 earnings total $2.7 billion. That means we shouldered all of the U.S. Government’s expenses for more than a half-day. Follow that thought a little further: If only 625 other U.S. taxpayers had paid the Treasury as much as we and General Re did last year, no one else — neither corporations nor 270 million citizens — would have had to pay federal income taxes or any other kind of federal tax (for example, social security or estate taxes). Our shareholders can truly say that they “gave at the office.” Writing checks to the IRS that include strings of zeros does not bother Charlie or me. Berkshire as a corporation, and we as individuals, have prospered in America as we would have in no other country. Indeed, if we lived in some other part of the world and completely escaped taxes, I’m sure we would be worse off financially (and in many other ways as well). Overall, we feel extraordinarily lucky to have been dealt a hand in life that enables us to write large checks to the government rather than one requiring the government to regularly write checks to us — say, because we are disabled or unemployed. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 13135-13143

First, we eliminate all of the ritualistic and nonproductive activities that normally go with the job of CEO. Our managers are totally in charge of their personal schedules. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 13199-13200

Second, we give each a simple mission: Just run your business as if: 1) you own 100% of it; 2) it is the only asset in the world that you and your family have or will ever have; and 3) you can’t sell or merge it for at least a century. As a corollary, we tell them they should not let any of their decisions be affected even slightly by accounting considerations. We want our managers to think about what counts, not how it will be counted. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 13200-13203

Ironically, though, a publicly-held reinsurer gets graded by both its owners and those who evaluate its credit on the smoothness of its own results. Wide swings in earnings hurt both credit ratings and p/e ratios, even when the business that produces such swings has an expectancy of satisfactory profits over time. This market reality sometimes causes a reinsurer to make costly moves, among them laying off a significant portion of the business it writes (in transactions that are called “retrocessions”) or rejecting good business simply because it threatens to bring on too much volatility. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 13265-13269

The key determinants are: (1) the amount of float that the business generates; (2) its cost; and (3) most important of all, the long-term outlook for both of these factors. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 13285-13287

Charlie and I have the easy jobs at Berkshire: We do very little except allocate capital. And, even then, we are not all that energetic. We have one excuse, though: In allocating capital, activity does not correlate with achievement. Indeed, in the fields of investments and acquisitions, frenetic behavior is often counterproductive. Therefore, Charlie and I mainly just wait for the phone to ring. Our managers, however, work very hard — and it shows. Naturally, they want to be paid fairly for their efforts, but pay alone can’t explain their extraordinary accomplishments. Instead, each is primarily motivated by a vision of just how far his or her business can go — and by a desire to be the one who gets it there. Charlie and I thank them on your behalf and ours. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 13328-13334

Once we knew that the General Re merger would definitely take place, we asked the company to dispose of the equities that it held. (As mentioned earlier, we do not manage the Cologne Re portfolio, which includes many equities.) General Re subsequently eliminated its positions in about 250 common stocks, incurring $935 million of taxes in the process. This “clean sweep” approach reflects a basic principle that Charlie and I employ in business and investing: We don’t back into decisions. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 13347-13350

Though the two plans are an economic wash, the cash plan we are putting in will produce a vastly different accounting result. This Alice-in-Wonderland outcome occurs because existing accounting principles ignore the cost of stock options when earnings are being calculated, even though options are a huge and increasing expense at a great many corporations. In effect, accounting principles offer management a choice: Pay employees in one form and count the cost, or pay them in another form and ignore the cost. Small wonder then that the use of options has mushroomed. This lop-sided choice has a big downside for owners, however: Though options, if properly structured, can be an appropriate, and even ideal, way to compensate and motivate top managers, they are more often wildly capricious in their distribution of rewards, inefficient as motivators, and inordinately -- Warren Buffett, Berkshire

Hathaway Letters to Shareholders, 2013, loc. 13371-13377

These managers start with the assumption, all too common, that their job at all times is to encourage the highest stock price possible (a premise with which we adamantly disagree). To pump the price, they strive, admirably, for operational excellence. But when operations don't produce the result hoped for, these CEOs resort to unadmirable accounting stratagems. These either manufacture the desired "earnings" or set the stage for them in the future. Rationalizing this behavior, these managers often say that their shareholders will be hurt if their currency for doing deals — that is, their stock — is not fully-priced, and they also argue that in using accounting shenanigans to get the figures they want, they are only doing what everybody else does. Once such an everybody's-doing-it attitude takes hold, ethical misgivings vanish. Call this behavior Son of Gresham: Bad accounting drives out good. The distortion du jour is the "restructuring charge," an accounting entry that can, of course, be legitimate but that too often is a device for manipulating earnings. In this bit of legerdemain, a large chunk of costs that should properly be attributed to a number of years is dumped into a single quarter, typically one already fated to disappoint investors. In some cases, the purpose of the charge is to clean up earnings misrepresentations of the past, and in others it is to prepare the ground for future misrepresentations. In either case, the size and timing of these charges is dictated by the cynical proposition that Wall Street will not mind if earnings fall short by $5 per share in a given quarter, just as long as this deficiency ensures that quarterly earnings in the future will consistently exceed expectations by five cents per share. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 13410-13422

When a p-c company is acquired, the buyer sometimes simultaneously increases its loss reserves, often substantially. This boost may merely reflect the previous inadequacy of reserves — though it is uncanny how often an actuarial "revelation" of this kind coincides with the inking of a deal. In any case, the move sets up the possibility of 'earnings" flowing into income at some later date, as reserves are released. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 13440-13443

I expect that the gain in Berkshire's intrinsic value over the next decade will modestly exceed the gain from owning the S&P. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 13572-13573

incentive compensation plans are now directly tied to the variables of float growth and cost of float, the same variables that determine value for owners. Even though a reinsurer may have a tightly focused and rational compensation system, it cannot count on every year coming up roses. Reinsurance is a highly volatile business, and neither General Re nor Ajit's operation is immune to bad pricing behavior in the industry. But General Re has the distribution , the underwriting skills, the culture, and — with Berkshire's backing — the financial clout to become the world's most profitable reinsurance company. Getting there will take time, energy and discipline, but we have no doubt that Ron Ferguson and his crew can make it happen. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 13680-13685

At Berkshire, we want to have compensation policies that are both easy to understand and in sync with what we wish our associates to accomplish. Writing new business is expensive (and, as mentioned, getting more expensive). If we were to include those costs in our calculation of bonuses — as managements did before our arrival at GEICO — we would be penalizing our associates for garnering new policies, even though these are very much in Berkshire's interest. So, in effect, we say to our associates that we will foot the bill for new business. Indeed, because percentage growth in policyholders is part of our compensation scheme, we reward our associates for producing this initially-unprofitable business. And then we reward them additionally for holding down costs on our seasoned business. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 13714-13720

Still, most of the planes we fly are owned by customers, which means that modest pre-tax margins in this business can produce good returns on equity. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 13757-13758

this exercise the bankers prepare a "book" that makes me think of the Superman comics of my youth. In the Wall Street version, a formerly mild-mannered company emerges from the investment banker's phone booth able to leap over competitors in a single bound and with earnings moving faster than a speeding bullet. Titillated by the book's description of the acquiree's powers, acquisition-hungry CEOs — Lois Lanes all, beneath their cool exteriors — promptly swoon. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 13778-13782

What's particularly entertaining in these books is the precision with which earnings are projected for many years ahead. If you ask the author-banker, however, what his own firm will earn next month, he will go into a protective crouch and tell you that business and markets are far too uncertain for him to venture a forecast. Here's one story I can't resist relating: In 1985, a major investment banking house undertook to sell Scott Fetzer, offering it widely — but with no success. Upon reading of this strikeout, I wrote Ralph Schey, then and now Scott Fetzer's CEO, expressing an interest in buying the business. I had never met Ralph, but within a week we had a deal. Unfortunately, Scott Fetzer's letter of engagement with the banking firm provided it a $2.5 million fee upon sale, even if it had nothing to do with finding the buyer. I guess the lead banker felt he should do something for his payment, so he graciously offered us a copy of the book on Scott Fetzer that his firm had prepared. With his customary tact, Charlie responded: "I'll pay $2.5 million not to read it." -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 13782-13789

For accounting rules to mandate amortization that will, in the usual case, conflict with reality is deeply troublesome: Most accounting charges relate to what's going on, even if they don't precisely measure it. As an example, depreciation charges can't with precision calibrate the decline in value that physical assets suffer, but these charges do at least describe something that is truly occurring: Physical assets invariably deteriorate. Correspondingly, obsolescence charges for inventories, bad debt charges for receivables and accruals for warranties are among the charges that reflect true costs. The annual charges for these expenses can't be exactly measured, but the necessity for estimating them is obvious. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 13835-13840

In contrast, economic goodwill does not, in many cases, diminish. Indeed, in a great many instances — perhaps most — it actually grows in value over time. In character, economic goodwill is much like land: The value of both assets is sure to fluctuate, but the direction in which value is going to go is in no way ordained. At See's, for example, economic goodwill has grown, in an irregular but very substantial manner, for 78 years. And, if we run the business right, growth of that kind will probably continue for at least another 78 years. To escape from the fiction of goodwill charges, managers embrace the fiction of pooling. This accounting convention is grounded in the poetic notion that when two rivers merge their streams become indistinguishable. Under this concept, a company that has been merged into a larger enterprise has not been "purchased" (even though it will often have received a large "sell-out" premium). Consequently, no goodwill is created, and those pesky subsequent charges to earnings are eliminated. Instead, the accounting for the ongoing entity is handled as if the businesses had forever been one unit. So much for poetry. The reality of merging is usually far different: There is indisputably an acquirer and an acquiree, and the latter has been "purchased," no matter how the deal has been structured. If you think otherwise, just ask employees severed from their jobs which company was the conqueror and which was the conquered. You will find no confusion. So on this point the FASB is correct: In most mergers, a purchase has been made. Yes, there are some true "mergers of equals," but they are few and far between. Charlie and I believe there's a reality-based approach that should both satisfy the FASB, which correctly wishes to record a purchase, and meet the objections of managements to nonsensical charges for diminution of goodwill. We would first have the acquiring company record its purchase price — whether paid in stock or cash — at fair value. In most cases, this procedure would create a large asset representing economic goodwill. We would then leave this asset on the books, not requiring its amortization. Later, if the economic goodwill became impaired, as it sometimes would, it would be written down just as would any other asset judged to be impaired. If our proposed rule were to be adopted, it should be applied retroactively so that acquisition accounting would be consistent throughout America — a far cry from what exists today. One prediction: If this plan were to take effect, managements would structure acquisitions more sensibly, deciding whether to use cash or stock based on the real consequences for their shareholders rather than on the unreal consequences for their reported earnings. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 13840-13860

Right now, the prices of the fine businesses we already own are just not that attractive. In other words, we feel much better about the businesses than their stocks. That's why we haven't added to our present holdings. Nevertheless, we haven't yet scaled back our portfolio in a major way: If the choice is between a questionable business at a comfortable price or a comfortable business at a questionable price, we much prefer the latter. What really gets our attention, however, is a comfortable business at a comfortable price. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 13924-13927

Usually the requests were rationally based, but a few leaned on spurious logic. There is only one combination of facts that makes it advisable for a company to repurchase its shares: First, the company has available funds — cash plus sensible borrowing capacity — beyond the near-term needs of the business and, second, finds its stock selling in the market below its intrinsic value, conservatively-calculated. To this we add a caveat: Shareholders should have been supplied all the information they need for estimating that value. Otherwise, insiders could take advantage of their uninformed partners and buy out their interests at a fraction of true worth. We have, on rare occasions, seen that happen. Usually, of course, chicanery is employed to drive stock prices up, not down. The business "needs" that I speak of are of two kinds: First, expenditures that a company must make to maintain its competitive position (e.g., the remodeling of stores at Helzberg's) and, second, optional outlays, aimed at business growth, that management expects will produce more than a dollar of value for each dollar spent (R. C. Willey's expansion into Idaho). When available funds exceed needs of those kinds, a company with a growth-oriented shareholder population can buy new businesses or repurchase shares. If a company's stock is selling well below intrinsic value, repurchases usually make the most sense. In the mid-1970s, the wisdom of making these was virtually screaming at managements, but few responded. In most cases, those that did made their owners much wealthier than if alternative courses of action had been pursued. Indeed, during the 1970s (and, spasmodically, for some years thereafter) we searched for companies that were large repurchasers of their shares. This often was a tipoff that the company was both undervalued and run by a shareholder-oriented management. That day is past. Now, repurchases are all the rage, but are all too often made for an unstated and, in our view, ignoble reason: to pump or support the stock price. The shareholder who chooses to sell today, of course, is benefitted by any buyer, whatever his origin or motives. But the continuing shareholder is penalized by repurchases above intrinsic value. Buying dollar bills for $1.10 is not good business for those who stick around. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 13941-13957

Just because stock has been issued to satisfy options — or for any other reason — does not mean that stock should be repurchased at a price above intrinsic value. Correspondingly, a stock that sells well below intrinsic value should be repurchased whether or not stock has previously been issued (or may be because of outstanding options). -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 13967-13969

Shaw has annual sales of about $4 billion, and we own 87.3% of the company. Leaving aside our insurance operation, Shaw is by far our largest business. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14154-14155

We find it meaningful when an owner cares about whom he sells to. We like to do business with someone who loves his company, not just the money that a sale will bring him (though we certainly understand why he likes that as well). When this emotional attachment exists, it signals that important qualities will likely be found within the business: honest accounting, pride of product, respect for customers, and a loyal group of associates having a strong sense of direction. The reverse is apt to be true, also. When an owner auctions off his business, exhibiting a total lack of interest in what follows, you will frequently find that it has been dressed up for sale, particularly when the seller is a "financial owner." And if owners behave with little regard for their business and its people, their conduct will often contaminate attitudes and practices throughout the company. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14184-14191

Under GAAP accounting, this "retroactive" insurance neither benefits nor penalizes our current earnings. Instead, we set up an asset called "deferred charges applicable to assumed reinsurance," in an amount reflecting the difference between the premium we receive and the (higher) losses we expect to pay (for which reserves are immediately established). We then amortize this asset by making annual charges to earnings that create equivalent underwriting losses. You will find the amount of the loss that we incur from these transactions in both our quarterly and annual management discussion. By their nature, these losses will continue for many years, often stretching into decades. As an offset, though, we have the use of float — lots of it. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14235-14240

Grab.com, an Internet company whose goal was to attract millions of people to its site and there to extract information from them that would be useful to marketers. To lure these people, Grab.com held out the possibility of a $1 billion prize (having a $170 million present value) and we insured its payment. A message on the site explained that the chance of anyone winning the prize was low, and indeed no one won. But the possibility of a win was far from nil. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14250-14253

Agonizing over errors is a mistake. But acknowledging and analyzing them can be useful, though that practice is rare in corporate boardrooms. There, Charlie and I have almost never witnessed a candid post-mortem of a failed decision, particularly one involving an acquisition. A notable exception to this never-look-back approach is that of The Washington Post Company, which unfailingly and objectively reviews its acquisitions three years after they are made. Elsewhere, triumphs are trumpeted, but dumb decisions either get no follow-up or are rationalized. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14275-14279

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Finally, the competitive picture changed in at least one important respect: State Farm — by far the largest personal auto insurer, with about 19% of the market — has been very slow to raise prices. Its costs, however, are clearly increasing right along with those of the rest of the industry. Consequently, State Farm had an underwriting loss last year from auto insurance (including rebates to policyholders) of 18% of premiums, compared to 4% at GEICO. Our loss produced a float cost for us of 6.1%, an unsatisfactory result. (Indeed, at GEICO we expect float, over time, to be free.) But we estimate that State Farm's float cost in 2000 was about 23%. The willingness of the largest player in the industry to tolerate such a cost makes the economics difficult for other participants. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14295-14300

The Farmer from Merna. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14308-14309

Many people assume that marketable securities are Berkshire's first choice when allocating capital, but that's not true: Ever since we first published our economic principles in 1983, we have consistently stated that we would rather purchase businesses than stocks. (See number 4 on page 60.) One reason for that preference is personal, in that I love working with our managers. They are high-grade, talented and loyal. And, frankly, I find their business behavior to be more rational and owner-oriented than that prevailing at many public companies. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14328-14332

But there's also a powerful financial reason behind the preference, and that has to do with taxes. The tax code makes Berkshire's owning 80% or more of a business far more profitable for us, proportionately, than our owning a smaller share. When a company we own all of earns $1 million after tax, the entire amount inures to our benefit. If the $1 million is upstreamed to Berkshire, we owe no tax on the dividend. And, if the earnings are retained and we were to sell the subsidiary — not likely at Berkshire! — for $1million more than we paid for it, we would owe no capital gains tax. That's because our "tax cost" upon sale would include both what we paid for the business and all earnings it subsequently retained. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14332-14337

Contrast that situation to what happens when we own an investment in a marketable security. There, if we own a 10% stake in a business earning $10 million after tax, our $1 million share of the earnings is subject to additional state and federal taxes of (1) about $140,000 if it is distributed to us (our tax rate on most dividends is 14%); or (2) no less than $350,000 if the $1 million is retained and subsequently captured by us in the form of a capital gain (on which our tax rate is usually about 35%, though it sometimes approaches 40%). We may defer paying the $350,000 by not immediately realizing our gain, but eventually we must pay the tax. In effect, the government is our "partner" twice when we own part of a business through a stock investment, but only once when we own at least 80%. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14337-14343

Leaving aside tax factors, the formula we use for evaluating stocks and businesses is identical. Indeed, the formula for valuing all assets that are purchased for financial gain has been unchanged since it was first laid out by a very smart man in about 600 B.C. (though he wasn't smart enough to know it was 600 B.C.). The oracle was Aesop and his enduring, though somewhat incomplete, investment insight was "a bird in the hand is worth two in the bush." To flesh out this principle, you must answer only three questions. How certain are you that there are indeed birds in the bush? When will they emerge and how many will there be? What is the risk-free interest rate (which we consider to be the yield on long-term U.S. bonds)? If you can answer these three questions, you will know the maximum value of the bush — and the maximum number of the birds you now possess that should be offered for it. And, of course, don't literally think birds. Think dollars. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14343-14349

Aesop's investment axiom, thus expanded and converted into dollars, is immutable. It applies to outlays for farms, oil royalties, bonds, stocks, lottery tickets, and manufacturing plants. And neither the advent of the steam engine, the harnessing of electricity nor the creation of the automobile changed the formula one iota — nor will the Internet. Just insert the correct numbers, and you can rank the attractiveness of all possible uses of capital throughout the universe. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14349-14353

Common yardsticks such as dividend yield, the ratio of price to earnings or to book value, and even growth rates have nothing to do with valuation except to the extent they provide clues to the amount and timing of cash flows into and from the business. Indeed, growth can destroy value if it requires cash inputs in the early years of a project or enterprise that exceed the discounted value of the cash that those assets will generate in later years. Market commentators and investment managers who glibly refer to "growth" and "value" styles as contrasting approaches to investment are displaying their ignorance, not their sophistication. Growth is simply a component — usually a plus, sometimes a minus — in the value equation. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14353-14358

Alas, though Aesop's proposition and the third variable — that is, interest rates — are simple, plugging in numbers for the other two variables is a difficult task. Using precise numbers is, in fact, foolish; working with a range of possibilities is the better approach. Usually, the range must be so wide that no useful conclusion can be reached. Occasionally, though, even very conservative estimates about the future emergence of birds reveal that the price quoted is startlingly low in relation to value. (Let's call this phenomenon the IBT — Inefficient Bush Theory.) To be sure, an investor needs some general understanding of business economics as well as the ability to think independently to reach a well-founded positive conclusion. But the investor does not need brilliance nor blinding insights. At the other extreme, there are many times when the most brilliant of investors can't muster a conviction about the birds to emerge, not even when a very broad range of estimates is employed. This kind of uncertainty frequently occurs when new businesses and rapidly changing industries are under examination. In cases of this sort, any capital commitment must be labeled speculative. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14358-14366

Now, speculation — in which the focus is not on what an asset will produce but rather on what the next fellow will pay for it — is neither illegal, immoral nor un-American. But it is not a game in which Charlie and I wish to play. We bring nothing to the party, so why should we expect to take anything home? The line separating investment and speculation, which is never bright and clear, becomes blurred still further when most market participants have recently enjoyed triumphs. Nothing sedates rationality like large doses of effortless money. After a heady experience of that kind, normally sensible people drift into behavior akin to that of Cinderella at the ball. They know that overstaying the festivities — that is, continuing to speculate in companies that have gigantic valuations relative to the cash they are likely to generate in the future — will eventually bring on pumpkins and mice. But they nevertheless hate to miss a single minute of what is one helluva party. Therefore, the giddy participants all plan to leave just seconds before midnight. There's a problem, though: They are dancing in a room in which the clocks have no hands. Last year, we commented on the exuberance — and, yes, it was irrational — that prevailed, noting that investor expectations had grown to be several multiples of probable returns. One piece of evidence came from a Paine Webber-Gallup survey of investors conducted in December 1999, in which the participants were asked their opinion about the annual returns investors could expect to realize over the decade ahead. Their answers averaged 19%. That, for sure, was an irrational expectation: For American business as a whole, there couldn't possibly be enough birds in the 2009 bush to deliver such a return. Far more irrational still were the huge valuations that market participants were then putting on businesses almost certain to end up being of modest or no value. Yet investors, mesmerized by soaring stock prices and ignoring all else, piled into these enterprises. It was as if some virus, racing wildly among investment professionals as well as amateurs, induced hallucinations in which the values of stocks in certain sectors became decoupled from the values of the businesses that underlay them. This surreal scene was accompanied by much loose talk about "value creation." We readily acknowledge that there has been a huge amount of true value created in the past decade by new or young businesses, and that there is much more to come. But value is destroyed, not created, by any business that loses money over its lifetime, no matter how high its interim valuation may get. What actually occurs in these cases is wealth transfer, often on a massive scale. By shamelessly merchandising birdless bushes, promoters have in recent years moved billions of dollars from the pockets of the public to their own purses (and to those of their friends and associates). The fact is that a bubble market has allowed the creation of bubble companies, entities designed more with an eye to making money off investors rather than for them. Too often, an IPO, not profits, was the primary goal of a company's promoters. At bottom, the "business model" for these companies has been the old-fashioned chain letter, for which many fee-hungry investment bankers acted as eager postmen. But a pin lies in wait for every bubble. And when the two eventually meet, a new wave of investors learns some very old lessons: First, many in Wall Street — a community in which quality control is not prized — will sell investors anything they will buy. Second, speculation is most dangerous when it looks easiest. At Berkshire, we make no attempt to pick the few winners that will emerge from an ocean of unproven enterprises. We're not smart enough to do that, and we know it. Instead, we try to apply Aesop's 2,600-year-old equation to opportunities in which we have reasonable confidence as to how many birds are in the bush and when they will emerge (a formulation that my grandsons would probably update to "A girl in a convertible is worth five in the phonebook."). Obviously, we can never precisely predict the timing of cash flows in and out of a business or their exact amount. We try, therefore, to keep our estimates conservative and to focus on industries where business surprises are unlikely to wreak havoc on owners. Even so, we make many mistakes: I'm the fellow, remember, who thought he understood the future economics of trading stamps, textiles, shoes and second-tier department stores. Lately, the most promising "bushes" have been negotiated transactions for entire businesses, and that pleases us. You should clearly understand, however, that these acquisitions will at best provide us only reasonable returns. Really juicy results from negotiated deals can be anticipated only when capital markets are severely constrained and the whole business world is pessimistic. We are 180 degrees from that point. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14366-14401

In our shoe businesses generally, our attempt to keep the bulk of our production in domestic factories has cost us dearly. We face another very tough year in 2001 also, as we make significant changes in how we do business. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14408-14409

clearly made a mistake in paying what I did for Dexter in 1993. Furthermore, I compounded that mistake in a huge way by using Berkshire shares in payment. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14409-14410

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We spent $272 million on flight simulators in 2000, and we'll spend a similar amount this year. Anyone who thinks that the annual charges for depreciation don't reflect a real cost — every bit as real as payroll or raw materials — should get an internship at a simulator company. Every year we spend amounts equal to our depreciation charge simply to stay in the same economic place — and then spend additional sums to grow. And growth is in prospect for FSI as far as the eye can see. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14417-14421

At Berkshire, full reporting means giving you the information that we would wish you to give to us if our positions were reversed. What Charlie and I would want under that circumstance would be all the important facts about current operations as well as the CEO's frank view of the long-term economic characteristics of the business. We would expect both a lot of financial details and a discussion of any significant data we would need to interpret what was presented. When Charlie and I read reports, we have no interest in pictures of personnel, plants or products. References to EBITDA make us shudder — does management think the tooth fairy pays for capital expenditures? We're very suspicious of accounting methodology that is vague or unclear, since too often that means management wishes to hide something. And we don't want to read messages that a public relations department or consultant has turned out. Instead, we expect a company's CEO to explain in his or her own words what's happening. For us, fair reporting means getting information to our 300,000 "partners" simultaneously, or as close to that mark as possible. We therefore put our annual and quarterly financials on the Internet between the close of the market on a Friday and the following morning. By our doing that, shareholders and other interested investors have timely access to these important releases and also have a reasonable amount of time to digest the information they include before the markets open on Monday. This year our quarterly information will be available on the Saturdays of May 12, August 11, and November 10. The 2001 annual report will be posted on March 9. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14444-14455

But for a major corporation to predict that its per-share earnings will grow over the long term at, say, 15% annually is to court trouble. That's true because a growth rate of that magnitude can only be maintained by a very small percentage of large businesses. Here's a test: Examine the record of, say, the 200 highest earning companies from 1970 or 1980 and tabulate how many have increased per-share earnings by 15% annually since those dates. You will find that only a handful have. I would wager you a very significant sum that fewer than 10 of the 200 most profitable companies in 2000 will attain 15% annual growth in earnings-per-share over the next 20 years. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14467-14471

Under his leadership, the company distributed $1.03 billion to Berkshire against our net purchase price of $230 million. We used these funds, in turn, to purchase other businesses. All told, Ralph's contributions to Berkshire's present value extend well into the billions of dollars. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14515-14517

Two years ago, reporting on 1999, I said that we had experienced both the worst absolute and relative performance in our history. I added that "relative results are what concern us," a viewpoint I've had since forming my first investment partnership on May 5, 1956. Meeting with my seven founding limited partners that evening, I gave them a short paper titled "The Ground Rules" that included this sentence: "Whether we do a good job or a poor job is to be measured against the general experience in securities." We initially used the Dow Jones Industrials as our benchmark, but shifted to the S&P 500 when that index became widely used. Our comparative record since 1965 is chronicled on the facing page; last year Berkshire's advantage was 5.7 percentage points. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14586-14591

Another of my 1956 Ground Rules remains applicable: "I cannot promise results to partners." But Charlie and I can promise that your economic result from Berkshire will parallel ours during the period of your ownership: We will not take cash compensation, restricted stock or option grants that would make our results superior to yours. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14599-14602

As they would not be if they had options, all of these managers are true owners. They face the downside of decisions as well as the upside. They incur a cost of capital. And they can't "reprice" their stakes: What they paid is what they live with. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14632-14634

Graham-Newman controlled Philadelphia and Reading Coal and Iron ("P&R"), an anthracite producer that had excess cash, a tax loss carryforward, and a declining business. At the time, I had a significant portion of my limited net worth invested in P&R shares, reflecting my faith in the business talents of my bosses, Ben Graham, Jerry Newman and Howard (Micky) Newman. This faith was rewarded when P&R purchased the Union Underwear Company from Jack Goldfarb for $15 million. Union (though it was then only a licensee of the name) produced Fruit of the Loom underwear. The company possessed $5 million in cash — $2.5 million of which P&R used for the purchase — and was earning about $3 million pre-tax, earnings that could be sheltered by the tax position of P&R. And, oh yes: Fully $9 million of the remaining $12.5 million due was satisfied by non-interest-bearing notes, payable from 50% of any earnings Union had in excess of $1 million. (Those were the days; I get goosebumps just thinking about such deals.) Subsequently, Union bought the licensor of the Fruit of the Loom name and, along with P&R, was merged into Northwest Industries. Fruit went on to achieve annual pre-tax earnings exceeding $200 million. John Holland was responsible for Fruit's operations in its most bountiful years. In 1996, however, John retired, and management loaded the company with debt, in part to make a series of acquisitions that proved disappointing. Bankruptcy followed. John was then rehired, and he undertook a major reworking of operations. Before John's return, deliveries were chaotic, costs soared and relations with key customers deteriorated. While correcting these problems, John also reduced employment from a bloated 40,000 to 23,000. In short, he's been restoring the old Fruit of the Loom, albeit in a much more competitive environment. Stepping into Fruit's bankruptcy proceedings, we made a proposal to creditors to which we attached no financing conditions, even though our offer had to remain outstanding for many months. We did, however, insist on a very unusual proviso: John had to be available to continue serving as CEO after we took over. To us, John and the brand are Fruit's key assets. I was helped in this transaction by my friend and former boss, Micky Newman, now 81. What goes around truly does come around. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14655-14671

What counts in this business is underwriting discipline. The winners are those that unfailingly stick to three key principles: They accept only those risks that they are able to properly evaluate (staying within their circle of competence) and that, after they have evaluated all relevant factors including remote loss scenarios, carry the expectancy of profit. These insurers ignore market-share considerations and are sanguine about losing business to competitors that are offering foolish prices or policy conditions. They limit the business they accept in a manner that guarantees they will suffer no aggregation of losses from a single event or from related events that will threaten their solvency. They ceaselessly search for possible correlation among seemingly-unrelated risks. They avoid business involving moral risk: No matter what the rate, trying to write good contracts with bad people doesn't work. While most policyholders and clients are honorable and ethical, doing business with the few exceptions is usually expensive, sometimes extraordinarily so. The events of September 11th made it clear that our implementation of rules 1 and 2 at General Re had been dangerously weak. In setting prices and also in evaluating aggregation risk, we had either overlooked or dismissed the possibility of large-scale terrorism losses. That was a relevant underwriting factor, and we ignored it. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14722-14732

correct rate for D&O "excess" (meaning the insurer or reinsurer will pay losses above a high threshold) might well, if based on exposure, be five or more times the premium dictated by experience. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14747-14748

Here's what we do know: (a) The probability of such mind-boggling disasters, though likely very low at present, is not zero. (b) The probabilities are increasing, in an irregular and immeasurable manner, as knowledge and materials become available to those who wish us ill. Fear may recede with time, but the danger won't — the war against terrorism can never be won. The best the nation can achieve is a long succession of stalemates. There can be no checkmate against hydra-headed foes. (c) Until now, insurers and reinsurers have blithely assumed the financial consequences from the incalculable risks I have described. (d) Under a "close-to-worst-case" scenario, which could conceivably involve $1 trillion of damage, the insurance industry would be destroyed unless it manages in some manner to dramatically limit its assumption of terrorism risks. Only the U.S. Government has the resources to absorb such a blow. If it is unwilling to do so on a prospective basis, the general citizenry must bear its own risks and count on the Government to come to its rescue after a disaster occurs. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14753-14761

Joe Brandon was appointed General Re's CEO in September and, along with Tad Montross, its new president, is committed to producing underwriting profits. Last fall, Charlie and I read Jack Welch's terrific book, Jack, Straight from the Gut (get a copy!). In discussing it, we agreed that Joe has many of Jack's characteristics: He is smart, energetic, hands-on, and expects much of both himself and his organization. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14784-14787

insurance reporting, "loss development" is a widely used term — and one that is seriously misleading. First, a definition: Loss reserves at an insurer are not funds tucked away for a rainy day, but rather a liability account. If properly calculated, the liability states the amount that an insurer will have to pay for all losses (including associated costs) that have occurred prior to the reporting date but have not yet been paid. When calculating the reserve, the insurer will have been notified of many of the losses it is destined to pay, but others will not yet have been reported to it. These losses are called IBNR, for incurred but not reported. Indeed, in some cases (involving, say, product liability or embezzlement) the insured itself will not yet be aware that a loss has occurred. It's clearly difficult for an insurer to put a figure on the ultimate cost of all such reported and unreported events. But the ability to do so with reasonable accuracy is vital. Otherwise the insurer's managers won't know what its actual loss costs are and how these compare to the premiums being charged. GEICO got into huge trouble in the early 1970s because for several years it severely underreserved, and therefore believed its product (insurance protection) was costing considerably less than was truly the case. Consequently, the company sailed blissfully along, underpricing its product and selling more and more policies at ever-larger losses. When it becomes evident that reserves at past reporting dates understated the liability that truly existed at the time, companies speak of "loss development." In the year discovered, these shortfalls penalize reported earnings because the "catch-up" costs from prior years must be added to current-year costs when results are calculated. This is what happened at General Re in 2001: a staggering $800 million of loss costs that actually occurred in earlier years, but that were not then recorded, were belatedly recognized last year and charged against current earnings. The mistake was an honest one, I can assure you of that. Nevertheless, for several years, this underreserving caused us to believe that our costs were much lower than they truly were, an error that contributed to woefully inadequate pricing. Additionally, the overstated profit figures led us to pay substantial incentive compensation that we should not have and to incur income taxes far earlier than was necessary. We recommend scrapping the term "loss development" and its equally ugly twin, "reserve strengthening." (Can you imagine an insurer, upon finding its reserves excessive, describing the reduction that follows as "reserve weakening"?) "Loss development" suggests to investors that some natural, uncontrollable event has occurred in the current year, and "reserve strengthening" implies that adequate amounts have been further buttressed. The truth, however, is that management made an error in estimation that in turn produced an error in the earnings previously reported. The losses didn't "develop" — they were there all along. What developed was management's understanding of the losses (or, in the instances of chicanery, management's willingness to finally fess up). A more forthright label for the phenomenon at issue would be "loss costs we failed to recognize when they occurred" (or maybe just "oops"). Underreserving, it should be noted, is a common — and serious — problem throughout the property/casualty insurance industry. At Berkshire we told you of our own problems with underestimation in 1984 and 1986. Generally, however, our reserving has been conservative. Major underreserving is common in cases of companies struggling for survival. In effect, insurance accounting is a self-graded exam, in that the insurer gives some figures to its auditing firm and generally doesn't get an argument. (What the auditor gets, however, is a letter from management that is designed to take his firm off the hook if the numbers later look silly.) A company experiencing financial difficulties — of a kind that, if truly faced, could put it out of business — seldom proves to be a tough grader. Who, after all, wants to prepare his own execution papers? Even when companies have the best of intentions, it's not easy to reserve properly. I've told the story in the past about the fellow traveling abroad whose sister called to tell him that their dad had died. The brother replied that it was impossible for him to get home for the funeral; he volunteered, however, to shoulder its cost. Upon returning, the brother received a bill from the mortuary for $4,500, which he promptly paid. A month later, and a month after that also, he paid $10 pursuant to an add-on invoice. When a third $10 invoice came, he called his sister for an explanation. "Oh," she replied, "I forgot to tell you. We buried dad in a rented suit." There are a lot of "rented suits" buried in the past operations of insurance companies. Sometimes the problems they signify lie dormant for decades, as was the case with asbestos liability, before virulently manifesting themselves. Difficult as the job may be, it's management's responsibility to adequately account for all possibilities. Conservatism is essential. When a claims manager walks into the CEO's office and says "Guess what just happened," his boss, if a veteran, does not expect to hear it's good news. Surprises in the insurance world have been far from symmetrical in their effect on earnings.

Because of this one-sided experience, it is folly to suggest, as some are doing, that all property/casualty insurance reserves be discounted, an approach reflecting the fact that they will be paid in the future and that therefore their present value is less than the stated liability for them. Discounting might be acceptable if reserves could be precisely established. They can't, however, because a myriad of forces — judicial broadening of policy language and medical inflation, to name just two chronic problems — are constantly working to make reserves inadequate. Discounting would exacerbate this already-serious situation and, additionally, would provide a new tool for the companies that are inclined to fudge. I'd say that the effects from telling a profit-challenged insurance CEO to lower reserves through discounting would be comparable to those that would ensue if a father told his 16-year-old son to have a normal sex life. Neither party needs that kind of push. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14826-14872

At MidAmerican — this may surprise you — we also own the second-largest residential real estate brokerage business in the country. We are market-share leaders in a number of large cities, primarily in the Midwest, and have recently acquired important firms in Atlanta and Southern California. Last year, operating under various names that are locally familiar, we handled about 106,000 transactions involving properties worth nearly $20 billion. Ron Peltier has built this business for us, and it's likely he will make more acquisitions in 2002 and the years to come. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14891-14895

Our restrained enthusiasm for these securities is matched by decidedly lukewarm feelings about the prospects for stocks in general over the next decade or so. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14936-14937

We have never purchased a newly-issued junk bond, which is the only kind most investors are urged to buy. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 14947-14948

our insurance operations are to generate low-cost float over time, they must: (a) underwrite with unwavering discipline; (b) reserve conservatively; and (c) avoid an aggregation of exposures that would allow a supposedly "impossible" incident to threaten their solvency. All of our major insurance businesses, with one exception, have regularly met those tests. The exception is General Re, and there was much to do at that company last year to get it up to snuff. I'm delighted to report that under Joe Brandon's leadership, and with yeoman assistance by Tad Montross, enormous progress has been made on each of the fronts described. When I agreed in 1998 to merge Berkshire with Gen Re, I thought that company stuck to the three rules I've enumerated. I had studied the operation for decades and had observed underwriting discipline that was consistent and reserving that was conservative. At merger time, I detected no slippage in Gen Re's standards. I was dead wrong. Gen Re's culture and practices had substantially changed and unbeknownst to management — and to me — the company was grossly mispricing its current business. In addition, Gen Re had accumulated an aggregation of risks that would have been fatal had, say, terrorists detonated several large-scale nuclear bombs in an attack on the U.S. A disaster of that scope was highly improbable, of course, but it is up to insurers to limit their risks in a manner that leaves their finances rock-solid if the "impossible" happens. Indeed, had Gen Re remained independent, the World Trade Center attack alone would have threatened the company's existence. When the WTC disaster occurred, it exposed weaknesses in Gen Re's operations that I should have detected earlier. But I was lucky: Joe and Tad were on hand, freshly endowed with increased authority and eager to rapidly correct the errors of the past. They knew what to do — and they did it. It takes time for insurance policies to run off, however, and 2002 was well along before we managed to reduce our aggregation of nuclear, chemical and biological risk (NCB) to a tolerable level. That problem is now behind us. On another front, Gen Re's underwriting attitude has been dramatically altered: The entire organization now understands that we wish to write only properly-priced business, whatever the effect on volume. Joe and Tad judge themselves only by Gen Re's underwriting profitability. Size simply doesn't count. Finally, we are making every effort to get our reserving right. If we fail at that, we can't know our true costs. And any insurer that has no idea what its costs are is heading for big trouble. At yearend 2001, General Re attempted to reserve adequately for all losses that had occurred prior to that date and were not yet paid — but we failed badly. Therefore the company's 2002 underwriting results were penalized by an additional $1.31 billion that we recorded to correct the estimation mistakes of earlier years. When I review the reserving errors that have been uncovered at General Re, a line from a country song seems apt: "I wish I didn't know now what I didn't know then." I can promise you that our top priority going forward is to avoid inadequate reserving. But I can't guarantee success. The natural tendency of most casualty-insurance managers is to underreserve, and they must have a particular mindset — which, it may surprise you, has nothing to do with actuarial expertise — if they are to overcome this devastating bias. Additionally, a reinsurer faces far more difficulties in reserving properly than does a primary insurer. Nevertheless, at Berkshire, we have generally been successful in our reserving, and we are determined to be at General Re as well. In summary, I believe General Re is now well positioned to deliver huge amounts of no-cost float to Berkshire and that its sink-the-ship catastrophe risk has been eliminated. The company still possesses the important competitive strengths that I've outlined in the past. And it gained another highly significant advantage last year when each of its three largest worldwide competitors, previously rated AAA, was demoted by at least one rating agency. Among the giants, General Re, rated AAA across-the-board, is now in a class by itself in respect to financial strength. No attribute is more important. Recently, in contrast, one of the world's largest reinsurers — a company regularly recommended to primary insurers by leading brokers — has all but ceased paying claims, including those both valid and due. This company owes many billions of dollars to hundreds of primary insurers who now face massive write-offs. "Cheap" reinsurance is a fool's bargain: When an insurer lays out money today in exchange for a reinsurer's promise to pay a decade or two later, it's dangerous — and possibly life-threatening — for the insurer to deal with any but the strongest reinsurer around. /P > Berkshire shareholders owe Joe and Tad a huge thank you for their accomplishments in 2002. They worked harder during the year than I would wish for anyone — and it is paying off. * * * * * * * * * * * * -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 15217-15254

We view them as time bombs, both for the parties that deal in them and the economic system. Having delivered that thought, which I'll get back to, let me retreat to explaining derivatives, though the explanation must be general because the word covers an extraordinarily wide range of financial contracts. Essentially, these instruments call for money to change hands at some future date, with the amount to be determined by one or more reference items, such as interest rates, stock prices or currency values. If, for example, you are either long or short an S&P 500 futures contract, you are a party to a very simple derivatives transaction — with your gain or loss derived from movements in the index. Derivatives contracts are of varying duration (running sometimes to 20 or more years) and their value is often tied to several variables. Unless derivatives contracts are collateralized or guaranteed, their ultimate value also depends on the creditworthiness of the counterparties to them. In the meantime, though, before a contract is settled, the counterparties record profits and losses — often huge in amount — in their current earnings statements without so much as a penny changing hands. The range of derivatives contracts is limited only by the imagination of man (or sometimes, so it seems, madmen). At Enron, for example, newsprint and broadband derivatives, due to be settled many years in the future, were put on the books. Or say you want to write a contract speculating on the number of twins to be born in Nebraska in 2020. No problem — at a price, you will easily find an obliging counterparty. When we purchased Gen Re, it came with General Re Securities, a derivatives dealer that Charlie and I didn't want, judging it to be dangerous. We failed in our attempts to sell the operation, however, and are now terminating it. But closing down a derivatives business is easier said than done. It will be a great many years before we are totally out of this operation (though we reduce our exposure daily). In fact, the reinsurance and derivatives businesses are similar: Like Hell, both are easy to enter and almost impossible to exit. In either industry, once you write a contract — which may require a large payment decades later — you are usually stuck with it. True, there are methods by which the risk can be laid off with others. But most strategies of that kind leave you with residual liability. Another commonality of reinsurance and derivatives is that both generate reported earnings that are often wildly overstated. That's true because today's earnings are in a significant way based on estimates whose inaccuracy may not be exposed for many years. Errors will usually be honest, reflecting only the human tendency to take an optimistic view of one's commitments. But the parties to derivatives also have enormous incentives to cheat in accounting for them. Those who trade derivatives are usually paid (in whole or part) on “earnings” calculated by mark-to-market accounting. But often there is no real market (think about our contract involving twins) and “mark-to-model” is utilized. This substitution can bring on large-scale mischief. As a general rule, contracts involving multiple reference items and distant settlement dates increase the opportunities for counterparties to use fanciful assumptions. In the twins scenario, for example, the two parties to the contract might well use differing models allowing both to show substantial profits for many years. In extreme cases, mark-to-model degenerates into what I would call mark-to-myth. Of course, both internal and outside auditors review the numbers, but that’s no easy job. For example, General Re Securities at yearend (after ten months of winding down its operation) had 14,384 contracts outstanding, involving 672 counterparties around the world. Each contract had a plus or minus value derived from one or more reference items, including some of mind-boggling complexity. Valuing a portfolio like that, expert auditors could easily and honestly have widely varying opinions. The valuation problem is far from academic: In recent years, some huge-scale frauds and near-frauds have been facilitated by derivatives trades. In the energy and electric utility sectors, for example, companies used derivatives and trading activities to report great “earnings” — until the roof fell in when they actually tried to convert the derivatives-related receivables on their balance sheets into cash. “Mark-to-market” then turned out to be truly “mark-to-myth.” I can assure you that the marking errors in the derivatives business have not been symmetrical. Almost invariably, they have favored either the trader who was eyeing a multi-million dollar bonus or the CEO who wanted to report impressive “earnings” (or both). The bonuses were paid, and the CEO profited from his options. Only much later did shareholders learn that the reported earnings were a sham. Another problem about derivatives is that they can exacerbate trouble that a corporation has run into for completely unrelated reasons. This pile-on effect occurs because many derivatives contracts require that a company suffering a credit downgrade immediately supply collateral to counterparties. Imagine, then, that a company is downgraded because of general adversity and that its derivatives instantly kick in with their requirement, imposing an unexpected and enormous demand for cash collateral on the company. The need to meet this demand can then throw the company into a liquidity crisis that may, in some cases, trigger still more downgrades. It all becomes a spiral that can lead to a corporate meltdown. Derivatives also create a daisy-chain risk that is akin to the risk run by insurers or reinsurers that lay off much of their business with others. In both cases, huge receivables from many counterparties tend to build up over time. (At Gen Re Securities, we still have $6.5 billion of receivables, though we’ve been in a liquidation mode for nearly a year.) A participant may see himself as prudent, believing his large credit exposures to be diversified and therefore not dangerous. Under certain circumstances, though, an exogenous event that causes the receivable from Company A to go bad will also affect those from Companies B through Z. History teaches us that a crisis often causes problems to correlate in a manner undreamed of in more tranquil times. In banking, the recognition of a “linkage” problem was one of the reasons for the formation of the Federal Reserve System. Before the Fed was established, the failure of weak banks would sometimes put sudden and unanticipated liquidity demands on previously-strong banks, causing them to fail in turn. The Fed now insulates the strong from the troubles of the weak. But there is no central bank assigned to the job of preventing the dominoes toppling in insurance or derivatives. In these industries, firms that are fundamentally solid can become troubled simply because of the travails of other firms further down the chain. When a “chain reaction” threat exists within an industry, it pays to minimize links of any kind. That’s how we conduct our reinsurance business, and it’s one reason we are exiting derivatives. Many people argue that derivatives reduce systemic problems, in that participants who can’t bear certain risks are able to transfer them to stronger hands. These people believe that derivatives act to stabilize the economy, facilitate trade, and eliminate bumps for individual participants. And, on a micro level, what they say is often true. Indeed, at Berkshire, I sometimes engage in large-scale derivatives transactions in order to facilitate certain investment strategies. Charlie and I believe, however, that the macro picture is dangerous and getting more so. Large amounts of risk, particularly credit risk, have become concentrated in the hands of relatively few derivatives dealers, who in addition trade extensively with one other. The troubles of one could quickly infect the others. On top of that, these dealers are owed huge amounts by non-dealer counterparties. Some of these counterparties, as I’ve mentioned, are linked in ways that could cause them to contemporaneously run into a problem because of a single event (such as the implosion of the telecom industry or the precipitous decline in the value of merchant power projects). Linkage, when it suddenly surfaces, can trigger serious systemic problems. Indeed, in 1998, the leveraged and derivatives-heavy activities of a single hedge fund, Long-Term Capital Management, caused the Federal Reserve anxieties so severe that it hastily orchestrated a rescue effort. In later Congressional testimony, Fed officials acknowledged that, had they not intervened, the outstanding trades of LTCM — a firm unknown to the general public and employing only a few hundred people — could well have posed a serious threat to the stability of American markets. In other words, the Fed acted because its leaders were fearful of what might have happened to other financial institutions had the LTCM domino toppled. And this affair, though it paralyzed many parts of the fixed-income market for weeks, was far from a worst-case scenario. One of the derivatives instruments that LTCM used was total-return swaps, contracts that facilitate 100% leverage in various markets, including stocks. For example, Party A to a contract, usually a bank, puts up all of the money for the purchase of a stock while Party B, without putting up any capital, agrees that at a future date it will receive any gain or pay any loss that the bank realizes. Total-return swaps of this type make a joke of margin requirements. Beyond that, other types of derivatives severely curtail the ability of regulators to curb leverage and generally get their arms around the risk profiles of banks, insurers and other financial institutions. Similarly, even experienced investors and analysts encounter major problems in analyzing the financial condition of firms that are heavily involved with derivatives contracts. When Charlie and I finish reading the long footnotes detailing the derivatives activities of major banks, the only thing we understand is that we don’t understand how much risk the institution is running. The derivatives genie is now well out of the bottle, and these instruments will almost certainly multiply in variety and number until some event makes their toxicity clear. Knowledge of how dangerous they are has already permeated the electricity and gas businesses, in which the eruption of major troubles caused the use of derivatives to diminish dramatically. Elsewhere, however, the derivatives business continues to expand unchecked. Central banks and governments have so far found no effective way to control, or even monitor, the risks posed by these contracts. Charlie and I believe Berkshire should be a fortress of financial strength — for the sake of our owners, creditors, policyholders and employees. We try to be alert to any sort of megacatastrophe risk, and that posture may make us unduly apprehensive about the burgeoning quantities of long-term derivatives contracts and the massive amount of uncollateralized receivables that are growing alongside. In our view, however, derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 15346-15425

Why have intelligent and decent directors failed so miserably? The answer lies not in inadequate laws — it’s always been clear that directors are obligated to represent the interests of shareholders — but rather in what I’d call “boardroom atmosphere.” It’s almost impossible, for example, in a boardroom populated by well-mannered people, to raise the question of whether the CEO should be replaced. It’s equally awkward to question a proposed acquisition that has been endorsed by the CEO, particularly when his inside staff and outside advisors are present and unanimously support his decision. (They wouldn’t be in the room if they didn’t.) Finally, when the compensation committee — armed, as always, with support from a high-paid consultant — reports on a megagrant of options to the CEO, it would be like belching at the dinner table for a director to suggest that the committee reconsider. These “social” difficulties argue for outside directors regularly meeting without the CEO — a reform that is being instituted and that I enthusiastically endorse. I doubt, however, that most of the other new governance rules and recommendations will provide benefits commensurate with the monetary and other costs they impose. The current cry is for “independent” directors. It is certainly true that it is desirable to have directors who think and speak independently — but they must also be business-savvy, interested and shareholder-oriented. In my 1993 commentary, those are the three qualities I described as essential. Over a span of 40 years, I have been on 19 public-company boards (excluding Berkshire’s) and have interacted with perhaps 250 directors. Most of them were “independent” as defined by today’s rules. But the great majority of these directors lacked at least one of the three qualities I value. As a result, their contribution to shareholder well-being was minimal at best and, too often, negative. These people, decent and intelligent though they were, simply did not know enough about business and/or care enough about shareholders to question foolish acquisitions or egregious compensation. My own behavior, I must ruefully add, frequently fell short as well: Too often I was silent when management made proposals that I judged to be counter to the interests of shareholders. In those cases, collegiality trumped independence. So that we may further see the failings of “independence,” let’s look at a 62-year case study covering thousands of companies. Since 1940, federal law has mandated that a large proportion of the directors of investment companies (most of these mutual funds) be independent. The requirement was originally 40% and now it is 50%. In any case, the typical fund has long operated with a majority of directors who qualify as independent. These directors and the entire board have many perfunctory duties, but in actuality have only two important responsibilities: obtaining the best possible investment manager and negotiating with that manager for the lowest possible fee. When you are seeking investment help yourself, those two goals are the only ones that count, and directors acting for other investors should have exactly the same priorities. Yet when it comes to independent directors pursuing either goal, their record has been absolutely pathetic. Many thousands of investment-company boards meet annually to carry out the vital job of selecting who will manage the savings of the millions of owners they represent. Year after year the directors of Fund A select manager A, Fund B directors select manager B, etc. … in a zombie-like process that makes a mockery of stewardship. Very occasionally, a board will revolt. But for the most part, a monkey will type out a Shakespeare play before an “independent” mutual-fund director will suggest that his fund look at other managers, even if the incumbent manager has persistently delivered substandard performance. When they are handling their own money, of course, directors will look to alternative advisors — but it never enters their minds to do so when they are acting as fiduciaries for others. The hypocrisy permeating the system is vividly exposed when a fund management company — call it “A” — is sold for a huge sum to Manager “B”. Now the “independent” directors experience a “counterrevelation” and decide that Manager B is the best that can be found — even though B was available (and ignored) in previous years. Not so incidentally, B also could formerly have been hired at a far lower rate than is possible now that it has bought Manager A. That’s because B has laid out a fortune to acquire A, and B must now recoup that cost through fees paid by the A shareholders who were “delivered” as part of the deal. (For a terrific discussion of the mutual fund business, read John Bogle’s Common Sense on Mutual Funds.) A few years ago, my daughter was asked to become a director of a family of funds managed by a major institution. The fees she would have received as a director were very substantial, enough to have increased her annual income by about 50% (a boost, she will tell you, she could use!). Legally, she would have been an independent director. But did the fund manager who approached her think there was any chance that she would think independently as to what advisor the fund should employ? Of course not. I am proud to say that she showed real independence by turning down the offer. The fund, however, had no trouble filling the slot (and — surprise — the fund has not changed managers). Investment company directors have failed as well in negotiating management fees (just as compensation committees of many American companies have failed to hold the compensation of their CEOs to sensible levels). If you or I were empowered, I can assure you that we could easily negotiate materially lower management fees with the incumbent managers of most mutual funds. And, believe me, if directors were promised a portion of any fee savings they realized, the skies would be filled with falling fees. Under the current system, though, reductions mean nothing to “independent” directors while meaning everything to managers. So guess who wins? Having the right money manager, of course, is far more important to a fund than reducing the manager’s fee. Both tasks are nonetheless the job of directors. And in stepping up to these all-important responsibilities, tens of thousands of “independent” directors, over more than six decades, have failed miserably. (They’ve succeeded, however, in taking care of themselves; their fees from serving on multiple boards of a single “family” of funds often run well into six figures.) When the manager cares deeply and the directors don’t, what’s needed is a powerful countervailing force — and that’s the missing element in today’s corporate governance. Getting rid of mediocre CEOs and eliminating overreaching by the able ones requires action by owners — big owners. The logistics aren’t that tough: The ownership of stock has grown increasingly concentrated in recent decades, and today it would be easy for institutional managers to exert their will on problem situations. Twenty, or even fewer, of the largest institutions, acting together, could effectively reform corporate governance at a given company, simply by withholding their votes for directors who were tolerating odious behavior. In my view, this kind of concerted action is the only way that corporate stewardship can be meaningfully improved. Unfortunately, certain major investing institutions have “glass house” problems in arguing for better governance elsewhere; they would shudder, for example, at the thought of their own performance and fees being closely inspected by their own boards. But Jack Bogle of Vanguard fame, Chris Davis of Davis Advisors, and Bill Miller of Legg Mason are now offering leadership in getting CEOs to treat their owners properly. Pension funds, as well as other fiduciaries, will reap better investment returns in the future if they support these men. The acid test for reform will be CEO compensation. Managers will cheerfully agree to board “diversity,” attest to SEC filings and adopt meaningless proposals relating to process. What many will fight, however, is a hard look at their own pay and perks. In recent years compensation committees too often have been tail-wagging puppy dogs meekly following recommendations by consultants, a breed not known for allegiance to the faceless shareholders who pay their fees. (If you can’t tell whose side someone is on, they are not on yours.) True, each committee is required by the SEC to state its reasoning about pay in the proxy. But the words are usually boilerplate written by the company’s lawyers or its human-relations department. This costly charade should cease. Directors should not serve on compensation committees unless they are themselves capable of negotiating on behalf of owners. They should explain both how they think about pay and how they measure performance. Dealing with shareholders’ money, moreover, they should behave as they would were it their own. In the 1890s, Samuel Gompers described the goal of organized labor as “More!” In the 1990s, America’s CEOs adopted his battle cry. The upshot is that CEOs have often amassed riches while their shareholders have experienced financial disasters. Directors should stop such piracy. There’s nothing wrong with paying well for truly exceptional business performance. But, for anything short of that, it’s time for directors to shout “Less!” It would be a travesty if the bloated pay of recent years became a baseline for future compensation. Compensation committees should go back to the drawing boards. * * * * * * * * * * * * -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 15461-15530

To find new directors, we will look through our shareholders list for people who directly, or in their family, have had large Berkshire holdings — in the millions of dollars — for a long time. Individuals making that cut should automatically meet two of our tests, namely that they be interested in Berkshire and shareholder-oriented. In our third test, we will look for business savvy, a competence that is far from commonplace. Finally, we will continue to have members of the Buffett family on the board. They are not there to run the business after I die, nor will they then receive compensation of any kind. Their purpose is to ensure, for both our shareholders and managers, that Berkshire’s special culture will be nurtured when I’m succeeded by other CEOs. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 15545-15551

Frequently, auditors knew about these deceptions. Too often, however, they remained silent. The key job of the audit committee is simply to get the auditors to divulge what they know. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 15559-15561

In my opinion, audit committees can accomplish this goal by asking four questions of auditors, the answers to which should be recorded and reported to shareholders. These questions are: If the auditor were solely responsible for preparation of the company’s financial statements, would they have in any way been prepared differently from the manner selected by management? This question should cover both material and nonmaterial differences. If the auditor would have done something differently, both management’s argument and the auditor’s response should be disclosed. The audit committee should then evaluate the facts. If the auditor were an investor, would he have received — in plain English — the information essential to his understanding the company’s financial performance during the reporting period? Is the company following the same internal audit procedure that would be followed if the auditor himself were CEO? If not, what are the differences and why? Is the auditor aware of any actions — either accounting or operational — that have had the purpose and effect of moving revenues or expenses from one reporting period to another? If the audit committee asks these questions, its composition — the focus of most reforms — is of minor importance. In addition, the procedure will save time and expense. When auditors are put on the spot, they will do their duty. If they are not put on the spot . . . well, we have seen the results of that. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 15567-15577

To its shame, the Senate voted 88-9 against expensing. Several prominent Senators even called for the demise of the FASB if it didn’t abandon its position. (So much for independence.) Arthur Levitt, Jr., then Chairman of the SEC — and generally a vigilant champion of shareholders — has since described his reluctant bowing to Congressional and corporate pressures as the act of his chairmanship that he most regrets. (The details of this sordid affair are related in Levitt's excellent book, Take on the Street.) With the Senate in its pocket and the SEC outgunned, corporate America knew that it was now boss when it came to accounting. With that, a new era of anything-goes earnings reports — blessed and, in some cases, encouraged by big-name auditors — was launched. The licentious behavior that followed quickly became an air pump for The Great Bubble. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 15595-15601

When managements take the low road in aspects that are visible, it is likely they are following a similar path behind the scenes. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 15611-15612

Trumpeting EBITDA (earnings before interest, taxes, depreciation and amortization) is a particularly pernicious practice. Doing so implies that depreciation is not truly an expense, given that it is a "non-cash" charge. That's nonsense. In truth, depreciation is a particularly unattractive expense because the cash outlay it represents is paid up front, before the asset acquired has delivered any benefits to the business. Imagine, if you will, that at the beginning of this year a company paid all of its employees for the next ten years of their service (in the way they would lay out cash for a fixed asset to be useful for ten years). In the following nine years, compensation would be a "non-cash" expense — a reduction of a prepaid compensation asset established this year. Would anyone care to argue that the recording of the expense in years two through ten would be simply a bookkeeping formality? Second, unintelligible footnotes usually indicate untrustworthy management. If you can't understand a footnote or other managerial explanation, it's usually because the CEO doesn't want you to. Enron's descriptions of certain transactions still baffle me. Finally, be suspicious of companies that trumpet earnings projections and growth expectations. Businesses seldom operate in a tranquil, no-surprise environment, and earnings simply don't advance smoothly (except, of course, in the offering books of investment bankers). Charlie and I not only don't know today what our businesses will earn next year — we don't even know what they will earn next quarter. We are suspicious of those CEOs who regularly claim they do know the future — and we become downright incredulous if they consistently reach their declared targets. Managers that always promise to "make the numbers" will at some point be tempted to make up the numbers. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 15613-15626

Over the decade following the 1955 merger of Berkshire Fine Spinning Associates and Hathaway Manufacturing, the combined operation had lost $10.1 million and many thousands of employees had been let go. It was not a marriage made in heaven. Against this background, we give you a picture of Berkshire's earnings growth that begins in 1968, but also includes subsequent base years spaced five years apart. A series of calculations is presented so that you can decide for yourself which period is most meaningful. I've started with 1968 because it was the first full year we operated National Indemnity, the initial acquisition we made as we began to expand Berkshire's business. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 15721-15726

(This structure does not guarantee perfect behavior, however: I've sat on boards of companies in which Berkshire had huge stakes and remained silent as questionable proposals were rubber-stamped.) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 15879-15881

again -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 15880

We have a $604 million investment in Value Capital, a partnership run by Mark Byrne, a member of a family that has helped Berkshire over the years in many ways. Berkshire is a limited partner in, and has no say in the management of, Mark's enterprise, which specializes in highly-hedged fixed-income opportunities. Mark is smart and honest and, along with his family, has a significant investment in Value. Because of accounting abuses at Enron and elsewhere, rules will soon be instituted that are likely to require that Value's assets and liabilities be consolidated on Berkshire's balance sheet. We regard this requirement as inappropriate, given that Value's liabilities — which usually are above $20 billion — are in no way ours. Over time, other investors will join us as partners in Value. When enough do, the need for us to consolidate Value will disappear. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 16044-16050

One piece of wisdom she imparted to the generations following her was, "If you have the lowest price, customers will find you at the bottom of a river." -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 16093-16094

NetJets will become a very big business over time and will be one in which we are preeminent in both customer satisfaction and profits. Rich will see to that. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 16120-16121

In 2003, however, many independent associates of The Pampered Chef began to feel the boycotts. This development meant that people who trusted us — but who were neither employees of ours nor had a voice in Berkshire decision-making — suffered serious losses of income. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 16166-16168

When we purchased the company — a specialist in commercial auto and general liability insurance — it did not appear to have any attributes that would overcome the industry's chronic troubles. It was not well-known, had no informational advantage (the company has never had an actuary), was not a low-cost operator, and sold through general agents, a method many people thought outdated. Nevertheless, for almost all of the past 38 years, NICO has been a star performer. Indeed, had we not made this acquisition, Berkshire would be lucky to be worth half of what it is today. What we've had going for us is a managerial mindset that most insurers find impossible to replicate. Take a look at the facing page. Can you imagine any public company embracing a business model that would lead to the decline in revenue that we experienced from 1986 through 1999? That colossal slide, it should be emphasized, did not occur because business was unobtainable. Many billions of premium dollars were readily available to NICO had we only been willing to cut prices. But we instead consistently priced to make a profit, not to match our most optimistic competitor. We never left customers — but they left us. Most American businesses harbor an "institutional imperative" that rejects extended decreases in volume. What CEO wants to report to his shareholders that not only did business contract last year but that it will continue to drop? In insurance, the urge to keep writing business is also intensified because the consequences of foolishly-priced policies may not become apparent for some time. If an insurer is optimistic in its reserving, reported earnings will be overstated, and years may pass before true loss costs are revealed (a form of self-deception that nearly destroyed GEICO in the early 1970s). -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 16292-16305

nico prof -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 16304

To combat employees' natural tendency to save their own skins, we have always promised NICO's workforce that no one will be fired because of declining volume, however severe the contraction. (This is not Donald Trump's sort of place.) NICO is not labor-intensive, and, as the table suggests, can live with excess overhead. It can't live, however, with underpriced business and the breakdown in underwriting discipline that accompanies it. An insurance organization that doesn't care deeply about underwriting at a profit this year is unlikely to care next year either. Naturally, a business that follows a no-layoff policy must be especially careful to avoid overstaffing when times are good. Thirty years ago Tom Murphy, then CEO of Cap Cities, drove this point home to me with a hypothetical tale about an employee who asked his boss for permission to hire an assistant. The employee assumed that adding $20,000 to the annual payroll would be inconsequential. But his boss told him the proposal should be evaluated as a $3 million decision, given that an additional person would probably cost at least that amount over his lifetime, factoring in raises, benefits and other expenses (more people, more toilet paper). And unless the company fell on very hard times, the employee added would be unlikely to be dismissed, however marginal his contribution to the business. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 16315-16325

We now operate 283 simulators with an original cost of $1.2 billion. Pilots are trained one at a time on this expensive equipment. This means that as much as $3.50 of capital investment is required to produce $1 of annual revenue. With this level of capital intensity, FlightSafety requires very high operating margins in order to obtain reasonable returns on capital, which means that utilization rates are all-important. Last year, FlightSafety's return on tangible equity improved to 15.1% from 8.4% in 2003. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 16477-16480

Nevertheless, I can properly be criticized for merely clucking about nose-bleed valuations during the Bubble rather than acting on my views. Though I said at the time that certain of the stocks we held were priced ahead of themselves, I underestimated just how severe the overvaluation was. I talked when I should have walked. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 16522-16525

Even then, it is typically not I who make the buying decisions. Lou Simpson manages about $2½ billion of equities that are held by GEICO, and it is his transactions that Berkshire is usually reporting. Customarily his purchases are in the $200-$300 million range and are in companies that are smaller than the ones I focus on. Take a look at the facing page to see why Lou is a cinch to be inducted into the investment Hall of Fame. You may be surprised to learn that Lou does not necessarily inform me about what he is doing. When Charlie and I assign responsibility, we truly hand over the baton — and we give it to Lou just as we do to our operating managers. Therefore, I typically learn of Lou's transactions about ten days after the end of each month. Sometimes, it should be added, I silently disagree with his decisions. But he's usually right. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 16544-16549

And, again, our usual caveat: macro-economics is a tough game in which few people, Charlie and I included, have demonstrated skill. We may well turn out to be wrong in our currency judgments -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 16619-16621

second reform concerns the "whistleblower line," an arrangement through which employees can send information to me and the board's audit committee without fear of reprisal. Berkshire's extreme decentralization makes this system particularly valuable both to me and the committee. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 16654-16656

So far, however, the moves made by institutions have been less than awe-inspiring. Usually, they've focused on minutiae and ignored the three questions that truly count. First, does the company have the right CEO? Second, is he/she overreaching in terms of compensation? Third, are proposed acquisitions more likely to create or destroy per-share value? -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 16662-16664

First, does the company have the right CEO? Second, is he/she overreaching in terms of compensation? Third, are proposed acquisitions more likely to create or destroy per-share value? -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 16663-16664

Measured by the biblical standard, the Berkshire board is a model: (a) every director is a member of a family owning at least $4 million of stock; (b) none of these shares were acquired from Berkshire via options or grants; (c) no directors receive committee, consulting or board fees from the company that are more than a tiny portion of their annual income; and (d) although we have a standard corporate indemnity arrangement, we carry no liability insurance for directors. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 16679-16682

my successor at Berkshire may well receive much of his pay via options, albeit logically-structured ones in respect to 1) an appropriate strike price, 2) an escalation in price that reflects the retention of earnings, and 3) a ban on his quickly disposing of any shares purchased through options. We cheer arrangements that motivate managers, whether these be cash bonuses or options. And if a company is truly receiving value for the options it issues, we see no reason why recording their cost should cut down on their use. The simple fact is that certain CEOs know their own compensation would be far more rationally determined if options were expensed. They also suspect that their stock would sell at a lower price if realistic accounting were employed, meaning that they would reap less in the market when they unloaded their personal holdings. To these CEOs such unpleasant prospects are a fate to be fought with all the resources they have at hand — even though the funds they use in that fight normally don't belong to them, but are instead put up by their shareholders. Option-expensing is scheduled to become mandatory on June 15th. You can therefore expect intensified efforts to stall or emasculate this rule between now and then. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 16709-16718

I failed in my attempt to exit painlessly, and in the meantime more trades were put on the books. Fault me for dithering. (Charlie calls it thumb-sucking.) When a problem exists, whether in personnel or in business operations, the time to act is now. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 16972-16974

In a sense, we are a canary in this business coal mine and should sing a song of warning as we expire. The number and value of derivative contracts outstanding in the world continues to mushroom and is now a multiple of what existed in 1998, the last time that financial chaos erupted. Our experience should be particularly sobering because we were a better-than-average candidate to exit gracefully. Gen Re was a relatively minor operator in the derivatives field. It has had the good fortune to unwind its supposedly liquid positions in a benign market, all the while free of financial or other pressures that might have forced it to conduct the liquidation in a less-than-efficient manner. Our accounting in the past was conventional and actually thought to be conservative. Additionally, we know of no bad behavior by anyone involved. It could be a different story for others in the future. Imagine, if you will, one or more firms (troubles often spread) with positions that are many multiples of ours attempting to liquidate in chaotic markets and under extreme, and well-publicized, pressures. This is a scenario to which much attention should be given now rather than after the fact. The time to have considered — and improved — the reliability of New Orleans' levees was before Katrina. When we finally wind up Gen Re Securities, my feelings about its departure will be akin to those expressed in a country song, "My wife ran away with my best friend, and I sure miss him a lot." -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 16975-16986

Before Jim Kilts arrived at Gillette in 2001, the company was struggling, having particularly suffered from capital-allocation blunders. In the major example, Gillette's acquisition of Duracell cost Gillette shareholders billions of dollars, a loss never made visible by conventional accounting. Quite simply, what Gillette received in business value in this acquisition was not equivalent to what it gave up. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17060-17063

Take, for instance, ten year, fixed-price options (and who wouldn't?). If Fred Futile, CEO of Stagnant, Inc., receives a bundle of these — let's say enough to give him an option on 1% of the company — his self-interest is clear: He should skip dividends entirely and instead use all of the company's earnings to repurchase stock. Let's assume that under Fred's leadership Stagnant lives up to its name. In each of the ten years after the option grant, it earns $1 billion on $10 billion of net worth, which initially comes to $10 per share on the 100 million shares then outstanding. Fred eschews dividends and regularly uses all earnings to repurchase shares. If the stock constantly sells at ten times earnings per share, it will have appreciated 158% by the end of the option period. That's because repurchases would reduce the number of shares to 38.7 million by that time, and earnings per share would thereby increase to $25.80. Simply by withholding earnings from owners, Fred gets very rich, making a cool $158 million, despite the business itself improving not at all. Astonishingly, Fred could have made more than $100 million if Stagnant's earnings had declined by 20% during the ten-year period. Fred can also get a splendid result for himself by paying no dividends and deploying the earnings he withholds from shareholders into a variety of disappointing projects and acquisitions. Even if these initiatives deliver a paltry 5% return, Fred will still make a bundle. Specifically — with Stagnant's p/e ratio remaining unchanged at ten — Fred's option will deliver him $63 million. Meanwhile, his shareholders will wonder what happened to the "alignment of interests" that was supposed to occur when Fred was issued options. A "normal" dividend policy, of course — one-third of earnings paid out, for example — produces less extreme results but still can provide lush rewards for managers who achieve nothing. CEOs understand this math and know that every dime paid out in dividends reduces the value of all outstanding options. I've never, however, seen this manager-owner conflict referenced in proxy materials that request approval of a fixed-priced option plan. Though CEOs invariably preach internally that capital comes at a cost, they somehow forget to tell shareholders that fixed-price options give them capital that is free. It doesn't have to be this way: It's child's play for a board to design options that give effect to the automatic build-up in value that occurs when earnings are retained. But — surprise, surprise — options of that kind are almost never issued. Indeed, the very thought of options with strike prices that are adjusted for retained earnings seems foreign to compensation "experts," who are nevertheless encyclopedic about every management-friendly plan that exists. ("Whose bread I eat, his song I sing.") Getting fired can produce a particularly bountiful payday for a CEO. Indeed, he can "earn" more in that single day, while cleaning out his desk, than an American worker earns in a lifetime of cleaning toilets. Forget the old maxim about nothing succeeding like success: Today, in the executive suite, the alltoo-prevalent rule is that nothing succeeds like failure. Huge severance payments, lavish perks and outsized payments for ho-hum performance often occur because comp committees have become slaves to comparative data. The drill is simple: Three or so directors — not chosen by chance — are bombarded for a few hours before a board meeting with pay statistics that perpetually ratchet upwards. Additionally, the committee is told about new perks that other managers are receiving. In this manner, outlandish "goodies" are showered upon CEOs simply because of a corporate version of the argument we all used when children: "But, Mom, all the other kids have one." When comp committees follow this "logic," yesterday's most egregious excess becomes today's baseline. Comp committees should adopt the attitude of Hank Greenberg, the Detroit slugger and a boyhood hero of mine. Hank's son, Steve, at one time was a player's agent. Representing an outfielder in negotiations with a major league club, Steve sounded out his dad about the size of the signing bonus he should ask for. Hank, a true pay-for-performance guy, got straight to the point, "What did he hit last year?" When Steve answered ".246," Hank's comeback was immediate: "Ask for a uniform." (Let me pause for a brief confession: In criticizing comp committee behavior, I don't speak as a true insider. Though I have served as a director of twenty public companies, only one CEO has put me on his comp committee. Hmmmm . . .) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17071-17105

The explanation of how this is happening begins with a fundamental truth: With unimportant exceptions, such as bankruptcies in which some of a company's losses are borne by creditors, the most that owners in aggregate can earn between now and Judgment Day is what their businesses in aggregate earn. True, by buying and selling that is clever or lucky, investor A may take more than his share of the pie at the expense of investor B. And, yes, all investors feel richer when stocks soar. But an owner can exit only by having someone take his place. If one investor sells high, another must buy high. For owners as a whole, there is simply no magic — no shower of money from outer space — that will enable them to extract wealth from their companies beyond that created by the companies themselves. Indeed, owners must earn less than their businesses earn because of "frictional" costs. And that's my point: These costs are now being incurred in amounts that will cause shareholders to earn far less than they historically have. To understand how this toll has ballooned, imagine for a moment that all American corporations are, and always will be, owned by a single family. We'll call them the Gotrocks. After paying taxes on dividends, this family — generation after generation — becomes richer by the aggregate amount earned by its companies. Today that amount is about $700 billion annually. Naturally, the family spends some of these dollars. But the portion it saves steadily compounds for its benefit. In the Gotrocks household everyone grows wealthier at the same pace, and all is harmonious. But let's now assume that a few fast-talking Helpers approach the family and persuade each of its members to try to outsmart his relatives by buying certain of their holdings and selling them certain others. The Helpers — for a fee, of course — obligingly agree to handle these transactions. The Gotrocks still own all of corporate America; the trades just rearrange who owns what. So the family's annual gain in wealth diminishes, equaling the earnings of American business minus commissions paid. The more that family members trade, the smaller their share of the pie and the larger the slice received by the Helpers. This fact is not lost upon these broker-Helpers: Activity is their friend and, in a wide variety of ways, they urge it on. After a while, most of the family members realize that they are not doing so well at this new "beatmy-brother" game. Enter another set of Helpers. These newcomers explain to each member of the Gotrocks clan that by himself he'll never outsmart the rest of the family. The suggested cure: "Hire a manager — yes, us — and get the job done professionally." These manager-Helpers continue to use the broker-Helpers to execute trades; the managers may even increase their activity so as to permit the brokers to prosper still more. Overall, a bigger slice of the pie now goes to the two classes of Helpers. The family's disappointment grows. Each of its members is now employing professionals. Yet overall, the group's finances have taken a turn for the worse. The solution? More help, of course. It arrives in the form of financial planners and institutional consultants, who weigh in to advise the Gotrocks on selecting manager-Helpers. The befuddled family welcomes this assistance. By now its members know they can pick neither the right stocks nor the right stock-pickers. Why, one might ask, should they expect success in picking the right consultant? But this question does not occur to the Gotrocks, and the consultant-Helpers certainly don't suggest it to them. The Gotrocks, now supporting three classes of expensive Helpers, find that their results get worse, and they sink into despair. But just as hope seems lost, a fourth group — we ll call them the hyper-Helpers — appears. These friendly folk explain to the Gotrocks that their unsatisfactory results are occurring because the existing Helpers — brokers, managers, consultants — are not sufficiently motivated and are simply going through the motions. "What," the new Helpers ask, "can you expect from such a bunch of zombies?" The new arrivals offer a breathtakingly simple solution: Pay more money. Brimming with self-confidence, the hyper-Helpers assert that huge contingent payments — in addition to stiff fixed fees — are what each family member must fork over in order to really outmaneuver his relatives. The more observant members of the family see that some of the hyper-Helpers are really just manager-Helpers wearing new uniforms, bearing sewn-on sexy names like HEDGE FUND or PRIVATE EQUITY. The new Helpers, however, assure the Gotrocks that this change of clothing is all-important, bestowing on its wearers magical powers similar to those acquired by mild-mannered Clark Kent when he changed into his Superman costume. Calmed by this explanation, the family decides to pay up. And that's where we are today: A record portion of the earnings that would go in their entirety to owners — if they all just stayed in their rocking chairs — is now going to a swelling army of Helpers. Particularly expensive is the recent pandemic of profit arrangements under which Helpers receive large portions of the winnings when they are smart or lucky, and leave family members with all of the losses — and large fixed fees to boot — when the Helpers are dumb or unlucky (or occasionally crooked). A sufficient number of arrangements like this — heads, the Helper takes much of the winnings; tails, the Gotrocks lose and pay dearly for the privilege of doing so — may make it more accurate to call the family the Hadrocks. Today, in fact, the family's frictional costs of all sorts may well amount to 20% of the earnings of American business. In other words, the burden of paying Helpers may cause American equity investors, overall, to earn only 80% or so of what they would earn if they just sat still and listened to no one. Long ago, Sir Isaac Newton gave us three laws of motion, which were the work of genius. But Sir Isaac's talents didn't extend to investing: He lost a bundle in the South Sea Bubble, explaining later, "I can calculate the movement of the stars, but not the madness of men." If he had not been traumatized by this loss, Sir Isaac might well have gone on to discover the Fourth Law of Motion: For investors as a whole, returns decrease as motion increases. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17130-17175

The other question that must be addressed is whether the Board will be prepared to make a change if that need should arise not from my death but rather from my decay, particularly if this decay is accompanied by my delusionally thinking that I am reaching new peaks of managerial brilliance. That problem would not be unique to me. Charlie and I have faced this situation from time to time at Berkshire's subsidiaries. Humans age at greatly varying rates — but sooner or later their talents and vigor decline. Some managers remain effective well into their 80s — Charlie is a wonder at 82 — and others noticeably fade in their 60s. When their abilities ebb, so usually do their powers of self-assessment. Someone else often needs to blow the whistle. When that time comes for me, our board will have to step up to the job. From a financial standpoint, its members are unusually motivated to do so. I know of no other board in the country in which the financial interests of directors are so completely aligned with those of shareholders. Few boards even come close. On a personal level, however, it is extraordinarily difficult for most people to tell someone, particularly a friend, that he or she is no longer capable. If I become a candidate for that message, however, our board will be doing me a favor by delivering it. Every share of Berkshire that I own is destined to go to philanthropies, and I want society to reap the maximum good from these gifts and bequests. It would be a tragedy if the philanthropic potential of my holdings was diminished because my associates shirked their responsibility to (tenderly, I hope) show me the door. But don't worry about this. We have an outstanding group of directors, and they will always do what's right for shareholders. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17224-17237

Tony Nicely, GEICO's CEO, went to work at the company 45 years ago, two months after turning 18. He became CEO in 1992, and from then on the company's growth exploded. In addition, Tony has delivered staggering productivity gains in recent years. Between yearend 2003 and yearend 2006, the number of GEICO policies increased from 5.7 million to 8.1 million, a jump of 42%. Yet during that same period, the company's employees (measured on a fulltime-equivalent basis) fell 3.5%. So productivity grew 47%. And GEICO didn't start fat. That remarkable gain has allowed GEICO to maintain its all-important position as a low-cost producer, even though it has dramatically increased advertising expenditures. Last year GEICO spent $631 million on ads, up from $238 million in 2003 (and up from $31 million in 1995, when Berkshire took control). Today, GEICO spends far more on ads than any of its competitors, even those much larger. We will continue to raise the bar. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17304-17310

The result: ISCAR makes money because it enables its customers to make more money. There is no better recipe for continued success. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17356-17357

40th anniversary of our entrance into the insurance business. It was on March 9, 1967, that Berkshire purchased National Indemnity and its companion company, National Fire & Marine, from Jack Ringwalt for $8.6 million. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17390-17392

I asked investment banker Charlie Heider, a mutual friend of mine and Jack's, to alert me the next time Jack was "in heat." When Charlie's call came, I sped to meet Jack. We made a deal in a few minutes, with me waiving an audit, "due diligence" or anything else that would give Jack an opportunity to reconsider. We just shook hands, and that was that. When we were due to close the purchase at Charlie's office, Jack was late. Finally arriving, he explained that he had been driving around looking for a parking meter with some unexpired time. That was a magic moment for me. I knew then that Jack was going to be my kind of manager. When Berkshire purchased Jack's two insurers, they had "float" of $17 million. We've regularly offered a long explanation of float in earlier reports, which you can read on our website. Simply put, float is money we hold that is not ours but which we get to invest. At the end of 2006, our float had grown to $50.9 billion, and we have since written a huge retroactive reinsurance contract with Equitas — which I will describe in the next section — that boosts float by another $7 billion. Much of the gain we've made has come through our acquisition of other insurers, but we've also had outstanding internal growth, particularly at Ajit Jain's amazing reinsurance operation. Naturally, I had no notion in 1967 that our float would develop as it has. There's much to be said for just putting one foot in front of the other every day. The float from retroactive reinsurance contracts, of which we have many, automatically drifts down over time. Therefore, it will be difficult for us to increase float in the future unless we make new acquisitions in the insurance field. Whatever its size, however, the all-important cost of Berkshire's float over time is likely to be significantly below that of the industry, perhaps even falling to less than zero. Note the words "over time." There will be bad years periodically. You can be sure of that. In 2006, though, everything went right in insurance — really right. Our managers — Tony Nicely (GEICO), Ajit Jain (B-H Reinsurance), Joe Brandon and Tad Montross (General Re), Don Wurster (National Indemnity Primary), Tom Nerney (U.S. Liability), Tim Kenesey (Medical Protective), Rod Eldred (Homestate Companies and Cypress), Sid Ferenc and Steve Menzies (Applied Underwriters), John Kizer (Central States) and Don Towle (Kansas Bankers Surety) — simply shot the lights out. When I recite their names, I feel as if I'm at Cooperstown, reading from the Hall of Fame roster. Of course, the overall insurance industry also had a terrific year in 2006. But our managers delivered results generally superior to those of their competitors. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17394-17413

Eventually, the names came to include many thousands of people from around the world, who joined expecting to pick up some extra change without effort or serious risk. True, prospective names were always solemnly told that they would have unlimited and everlasting liability for the consequences of their syndicate's underwriting — "down to the last cufflink," as the quaint description went. But that warning came to be viewed as perfunctory. Three hundred years of retained cufflinks acted as a powerful sedative to the names poised to sign up. Then came asbestos. When its prospective costs were added to the tidal wave of environmental and product claims that surfaced in the 1980s, Lloyd's began to implode. Policies written decades earlier — and largely forgotten about — were developing huge losses. No one could intelligently estimate their total, but it was certain to be many tens of billions of dollars. The specter of unending and unlimited losses terrified existing names and scared away prospects. Many names opted for bankruptcy; some even chose suicide. From these shambles, there came a desperate effort to resuscitate Lloyd's. In 1996, the powers that be at the institution allotted £11.1 billion to a new company, Equitas, and made it responsible for paying all claims on policies written before 1993. In effect, this plan pooled the misery of the many syndicates in trouble. Of course, the money allotted could prove to be insufficient — and if that happened, the names remained liable for the shortfall. But the new plan, by concentrating all of the liabilities in one place, had the advantage of eliminating much of the costly intramural squabbling that went on among syndicates. Moreover, the pooling allowed claims evaluation, negotiation and litigation to be handled more intelligently than had been the case previously. Equitas embraced Ben Franklin's thinking: "We must all hang together, or assuredly we shall hang separately." From the start, many people predicted Equitas would eventually fail. But as Ajit and I reviewed the facts in the spring of 2006 — 13 years after the last exposed policy had been written and after the payment of £11.3 billion in claims — we concluded that the patient was likely to survive. And so we decided to offer a huge reinsurance policy to Equitas. Because plenty of imponderables continue to exist, Berkshire could not provide Equitas, and its 27,972 names, unlimited protection. But we said — and I'm simplifying — that if Equitas would give us $7.12 billion in cash and securities (this is the float I spoke about), we would pay all of its future claims and expenses up to $13.9 billion. That amount was $5.7 billion above what Equitas had recently guessed its ultimate liabilities to be. Thus the names received a huge — and almost certainly sufficient — amount of future protection against unpleasant surprises. Indeed the protection is so large that Equitas plans a cash payment to its thousands of names, an event few of them had ever dreamed possible. And how will Berkshire fare? That depends on how much "known" claims will end up costing us, how many yet-to-be-presented claims will surface and what they will cost, how soon claim payments will be made and how much we earn on the cash we receive before it must be paid out. Ajit and I think the odds are in our favor. And should we be wrong, Berkshire can handle it. Scott Moser, the CEO of Equitas, summarized the transaction neatly: "Names wanted to sleep easy at night, and we think we've just bought them the world's best mattress.&ddquo; -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17437-17463

So let us summarize our accounting for the Equitas transaction. The major debits will be to Cash and Investments, Reinsurance Recoverable, and Deferred Charges for Reinsurance Assumed ("DCRA"). The major credit will be to Reserve for Losses and Loss Adjustment Expense. No profit or loss will be recorded at the inception of the transaction, but underwriting losses will thereafter be incurred annually as the DCRA asset is amortized downward. The amount of the annual amortization charge will be primarily determined by how our end-of-the-year estimates as to the timing and amount of future loss payments compare to the estimates made at the beginning of the year. Eventually, when the last claim has been paid, the DCRA account will be reduced to zero. That day is 50 years or more away. What's important to remember is that retroactive insurance contracts always produce underwriting losses for us. Whether these losses are worth experiencing depends on whether the cash we have received produces investment income that exceeds the losses. Recently our DCRA charges have annually delivered $300 million or so of underwriting losses, which have been more than offset by the income we have realized through use of the cash we received as a premium. Absent new retroactive contracts, the amount of the annual charge would normally decline over time. After the Equitas transaction, however, the annual DCRA cost will initially increase to about $450 million a year. This means that our other insurance operations must generate at least that much underwriting gain for our overall float to be cost-free. That amount is quite a hurdle but one that I believe we will clear in many, if not most, years. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17473-17484

71,699 per share. Despite its making 14 acquisitions, -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17498-17498

great majority of families therefore felt the need for a paper every day, but understandably most didn't wish to pay for two. Advertisers preferred the paper with the most circulation, and readers tended to want the paper with the most ads and news pages. This circularity led to a law of the newspaper jungle: Survival of the Fattest. Thus, when two or more papers existed in a major city (which was almost universally the case a century ago), the one that pulled ahead usually emerged as the stand-alone winner. After competition disappeared, the paper's pricing power in both advertising and circulation was unleashed. Typically, rates for both advertisers and readers would be raised annually — and the profits rolled in. For owners this was economic heaven. (Interestingly, though papers regularly — and often in a disapproving way — reported on the profitability of, say, the auto or steel industries, they never enlightened readers about their own Midas-like situation. Hmmm . . .) As long ago as my 1991 letter to shareholders, I nonetheless asserted that this insulated world was changing, writing that "the media businesses . . . will prove considerably less marvelous than I, the industry, or lenders thought would be the case only a few years ago." Some publishers took umbrage at both this remark and other warnings from me that followed. Newspaper properties, moreover, continued to sell as if they were indestructible slot machines. In fact, many intelligent newspaper executives who regularly chronicled and analyzed important worldwide events were either blind or indifferent to what was going on under their noses. Now, however, almost all newspaper owners realize that they are constantly losing ground in the battle for eyeballs. Simply put, if cable and satellite broadcasting, as well as the internet, had come along first, newspapers as we know them probably would never have existed. In Berkshire's world, Stan Lipsey does a terrific job running the Buffalo News, and I am enormously proud of its editor, Margaret Sullivan. The News' penetration of its market is the highest among that of this country's large newspapers. We also do better financially than most metropolitan newspapers, even though Buffalo's population and business trends are not good. Nevertheless, this operation faces unrelenting pressures that will cause profit margins to slide. True, we have the leading online news operation in Buffalo, and it will continue to attract more viewers and ads. However, the economic potential of a newspaper internet site — given the many alternative sources of information and entertainment that are free and only a click away — is at best a small fraction of that existing in the past for a print newspaper facing no competition. For a local resident, ownership of a city's paper, like ownership of a sports team, still produces instant prominence. With it typically comes power and influence. These are ruboffs that appeal to many people with money. Beyond that, civic-minded, wealthy individuals may feel that local ownership will serve their community well. That's why Peter Kiewit bought the Omaha paper more than 40 years ago. We are likely therefore to see non-economic individual buyers of newspapers emerge, just as we have seen such buyers acquire major sports franchises. Aspiring press lords should be careful, however: There's no rule that says a newspaper's revenues can't fall below its expenses and that losses can't mushroom. Fixed costs are high in the newspaper business, and that's bad news when unit volume heads south. As the importance of newspapers diminishes, moreover, the "psychic" value of possessing one will wane, whereas owning a sports franchise will likely retain its cachet. Unless we face an irreversible cash drain, we will stick with the News, just as we've said that we would. (Read economic principle 11, on page 76.) Charlie and I love newspapers — we each read five a day — and believe that a free and energetic press is a key ingredient for maintaining a great democracy. We hope that some combination of print and online will ward off economic doomsday for newspapers, and we will work hard in Buffalo to develop a sustainable business model. I think we will be successful. But the days of lush profits from our newspaper are over. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17511-17541

This company has never had a problem growing: Revenues from flight operations have increased 596% since our purchase in 1998. But profits had been erratic. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17542-17543

We've also wound up our investment in Value Capital. So earnings or losses from these two lines of business are making their final appearance in -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17576-17577

-- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17589-17589

I have told you that Berkshire has three outstanding candidates to replace me as CEO and that the Board knows exactly who should take over if I should die tonight. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17628-17629

Under this plan, I intend to hire a younger man or woman with the potential to manage a very large portfolio, who we hope will succeed me as Berkshire's chief investment officer when the need for someone to do that arises. As part of the selection process, we may in fact take on several candidates. Picking the right person(s) will not be an easy task. It's not hard, of course, to find smart people, among them individuals who have impressive investment records. But there is far more to successful long-term investing than brains and performance that has recently been good. Over time, markets will do extraordinary, even bizarre, things. A single, big mistake could wipe out a long string of successes. We therefore need someone genetically programmed to recognize and avoid serious risks, including those never before encountered. Certain perils that lurk in investment strategies cannot be spotted by use of the models commonly employed today by financial institutions. Temperament is also important. Independent thinking, emotional stability, and a keen understanding of both human and institutional behavior is vital to long-term investment success. I've seen a lot of very smart people who have lacked these virtues. Finally, we have a special problem to consider: our ability to keep the person we hire. Being able to list Berkshire on a resume would materially enhance the marketability of an investment manager. We will need, therefore, to be sure we can retain our choice, even though he or she could leave and make much more money elsewhere. There are surely people who fit what we need, but they may be hard to identify. In 1979, Jack Byrne and I felt we had found such a person in Lou Simpson. We then made an arrangement with him whereby he would be paid well for sustained overperformance. Under this deal, he has earned large amounts. Lou, however, could have left us long ago to manage far greater sums on more advantageous terms. If money alone had been the object, that's exactly what he would have done. But Lou never considered such a move. We need to find a younger person or two made of the same stuff. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17634-17649

Our federal return last year, we should add, ran to 9,386 pages. To handle this filing, state and foreign tax returns, a myriad of SEC requirements, and all of the other matters involved in running Berkshire, we have gone all the way up to 19 employees at World Headquarters. This crew occupies 9,708 square feet of space, and Charlie — at World Headquarters West in Los Angeles — uses another 655 square feet. Our home-office payroll, including benefits and counting both locations, totaled $3,531,978 last year. We're careful when spending your money. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17679-17682

In 1970, indeed, about 60 billion of our stamps were licked by savers, pasted into books, and taken to Blue Chip redemption stores. Our catalog of rewards was 116 pages thick and chock full of tantalizing items. When I was told that even certain brothels and mortuaries gave stamps to their patrons, I felt I had finally found a sure thing. Well, not quite. From the day Charlie and I stepped into the Blue Chip picture, the business went straight downhill. By 1980, sales had fallen to $19.4 million. And, by 1990, sales were bumping along at $1.5 million. No quitter, I redoubled my managerial efforts. Sales then fell another 98%. Last year, in Berkshire's $98 billion of revenues, all of $25,920 (no zeros omitted) came from Blue Chip. Ever hopeful, Charlie and I soldier on. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17692-17697

I've stipulated that the proceeds from all Berkshire shares I still own at death are to be used for philanthropic purposes within ten years after my estate is closed. Because my affairs are not complicated, it should take three years at most for this closing to occur. Adding this 13-year period to my expected lifespan of about 12 years (though, naturally, I'm aiming for more) means that proceeds from all of my Berkshire shares will likely be distributed for societal purposes over the next 25 years or so. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17724-17728

A flood of money went from institutional investors to the 2-and-20 crowd. For those innocent of this arrangement, let me explain: It's a lopsided system whereby 2% of your principal is paid each year to the manager even if he accomplishes nothing — or, for that matter, loses you a bundle — and, additionally, 20% of your profit is paid to him if he succeeds, even if his success is due simply to a rising tide. For example, a manager who achieves a gross return of 10% in a year will keep 3.6 percentage points — two points off the top plus 20% of the residual 8 points — leaving only 6.4 percentage points for his investors. On a $3 billion fund, this 6.4% net "performance" will deliver the manager a cool $108 million. He will receive this bonanza even though an index fund might have returned 15% to investors in the same period and charged them only a token fee. The inexorable math of this grotesque arrangement is certain to make the Gotrocks family poorer over time than it would have been had it never heard of these "hyper-helpers." Even so, the 2-and-20 action spreads. Its effects bring to mind the old adage: When someone with experience proposes a deal to someone with money, too often the fellow with money ends up with the experience, and the fellow with experience ends up with the money. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17757-17766

Walter managed a remarkably successful investment partnership, from which he took not a dime unless his investors made money. My admiration for Walter, it should be noted, is not based on hindsight. A full fifty years ago, Walter was my sole recommendation to a St. Louis family who wanted an honest and able investment manager. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17768-17770

Among them are Seeking Wisdom: From Darwin to Munger by Peter Bevelin, a long-time Swedish shareholder of Berkshire, and Fred Schwed's classic, Where are the Customers' Yachts? This book was first published in 1940 and is now in its 4th edition. The funniest book ever written about investing, it lightly delivers many truly important messages on the subject. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17812-17815

Some major financial institutions have, however, experienced staggering problems because they engaged in the "weakened lending practices" I described in last year's letter. John Stumpf, CEO of Wells Fargo, aptly dissected the recent behavior of many lenders: "It is interesting that the industry has invented new ways to lose money when the old ways seemed to work just fine." You may recall a 2003 Silicon Valley bumper sticker that implored, "Please, God, Just One More Bubble." Unfortunately, this wish was promptly granted, as just about all Americans came to believe that house prices would forever rise. That conviction made a borrower's income and cash equity seem unimportant to lenders, who shoveled out money, confident that HPA — house price appreciation — would cure all problems. Today, our country is experiencing widespread pain because of that erroneous belief. As house prices fall, a huge amount of financial folly is being exposed. You only learn who has been swimming naked when the tide goes out — and what we are witnessing at some of our largest financial institutions is an ugly sight. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17860-17868

This float is "free" as long as insurance underwriting breaks even, meaning that the premiums we receive equal the losses and expenses we incur. Of course, insurance underwriting is volatile, swinging erratically between profits and losses. Over our entire history, however, we've been profitable, and I expect we will average breakeven results or better in the future. If we do that, our investments can be viewed as an unencumbered source of value for Berkshire shareholders. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17879-17882

A second, somewhat related, point about these managers is that they have exactly the job they want for the rest of their working years. At almost any other company, key managers below the top aspire to keep climbing the pyramid. For them, the subsidiary or division they manage today is a way station — or so they hope. Indeed, if they are in their present positions five years from now, they may well feel like failures. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17897-17900

Their decisions flow from a here-today, here-forever mindset. I think our rare and hard-to-replicate managerial structure gives Berkshire a real advantage. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17901-17902

The seeds of this transaction were planted in 1954. That fall, only three months into a new job, I was sent by my employers, Ben Graham and Jerry Newman, to a shareholders' meeting of Rockwood Chocolate in Brooklyn. A young fellow had recently taken control of this company, a manufacturer of assorted cocoa-based items. He had then initiated a one-of-a-kind tender, offering 80 pounds of cocoa beans for each share of Rockwood stock. I described this transaction in a section of the 1988 annual report that explained arbitrage. I also told you that Jay Pritzker — the young fellow mentioned above — was the business genius behind this tax-efficient idea, the possibilities for which had escaped all the other experts who had thought about buying Rockwood, including my bosses, Ben and Jerry. At the meeting, Jay was friendly and gave me an education on the 1954 tax code. I came away very impressed. Thereafter, I avidly followed Jay's business dealings, which were many and brilliant. His valued partner was his brother, Bob, who for nearly 50 years ran Marmon Group, the home for most of the Pritzker businesses. Jay died in 1999, and Bob retired early in 2002. Around then, the Pritzker family decided to gradually sell or reorganize certain of its holdings, including Marmon, a company operating 125 businesses, managed through nine sectors. Marmon's largest operation is Union Tank Car, which together with a Canadian counterpart owns 94,000 rail cars that are leased to various shippers. The original cost of this fleet is $5.1 billion. All told, Marmon has $7 billion in sales and about 20,000 employees. We will soon purchase 60% of Marmon and will acquire virtually all of the balance within six years. Our initial outlay will be $4.5 billion, and the price of our later purchases will be based on a formula tied to earnings. Prior to our entry into the picture, the Pritzker family received substantial consideration from Marmon's distribution of cash, investments and certain businesses. This deal was done in the way Jay would have liked. We arrived at a price using only Marmon's financial statements, employing no advisors and engaging in no nit-picking. I knew that the business would be exactly as the Pritzkers represented, and they knew that we would close on the dot, however chaotic financial markets might be. During the past year, many large deals have been renegotiated or killed entirely. With the Pritzkers, as with Berkshire, a deal is a deal. Marmon's CEO, Frank Ptak, works closely with a long-time associate, John Nichols. John was formerly the highly successful CEO of Illinois Tool Works (ITW), where he teamed with Frank to run a mix of industrial businesses. Take a look at their ITW record; you ll be impressed. Byron Trott of Goldman Sachs — whose praises I sang in the 2003 report — facilitated the Marmon transaction. Byron is the rare investment banker who puts himself in his client's shoes. Charlie and I trust him completely. You'll like the code name that Goldman Sachs assigned the deal. Marmon entered the auto business in 1902 and exited it in 1933. Along the way it manufactured the Wasp, a car that won the first Indianapolis 500 race, held in 1911. So this deal was labeled "Indy 500." -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17904-17927

A truly great business must have an enduring "moat" that protects excellent returns on invested capital. The dynamics of capitalism guarantee that competitors will repeatedly assault any business "castle" that is earning high returns. Therefore a formidable barrier such as a company's being the low-cost producer (GEICO, Costco) or possessing a powerful world-wide brand (Coca-Cola, Gillette, American Express) is essential for sustained success. Business history is filled with "Roman Candles," companies whose moats proved illusory and were soon crossed. Our criterion of "enduring" causes us to rule out companies in industries prone to rapid and continuous change. Though capitalism's "creative destruction" is highly beneficial for society, it precludes investment certainty. A moat that must be continuously rebuilt will eventually be no moat at all. Additionally, this criterion eliminates the business whose success depends on having a great manager. Of course, a terrific CEO is a huge asset for any enterprise, and at Berkshire we have an abundance of these managers. Their abilities have created billions of dollars of value that would never have materialized if typical CEOs had been running their businesses. But if a business requires a superstar to produce great results, the business itself cannot be deemed great. A medical partnership led by your area's premier brain surgeon may enjoy outsized and growing earnings, but that tells little about its future. The partnership's moat will go when the surgeon goes. You can count, though, on the moat of the Mayo Clinic to endure, even though you can't name its CEO. Long-term competitive advantage in a stable industry is what we seek in a business. If that comes with rapid organic growth, great. But even without organic growth, such a business is rewarding. We will simply take the lush earnings of the business and use them to buy similar businesses elsewhere. There's no rule that you have to invest money where you've earned it. Indeed, it's often a mistake to do so: Truly great businesses, earning huge returns on tangible assets, can't for any extended period reinvest a large portion of their earnings internally at high rates of return. Let's look at the prototype of a dream business, our own See's Candy. The boxed-chocolates industry in which it operates is unexciting: Per-capita consumption in the U.S. is extremely low and doesn't grow. Many once-important brands have disappeared, and only three companies have earned more than token profits over the last forty years. Indeed, I believe that See's, though it obtains the bulk of its revenues from only a few states, accounts for nearly half of the entire industry's earnings. At See's, annual sales were 16 million pounds of candy when Blue Chip Stamps purchased the company in 1972. (Charlie and I controlled Blue Chip at the time and later merged it into Berkshire.) Last year See's sold 31 million pounds, a growth rate of only 2% annually. Yet its durable competitive advantage, built by the See's family over a 50-year period, and strengthened subsequently by Chuck Huggins and Brad Kinstler, has produced extraordinary results for Berkshire. We bought See's for $25 million when its sales were $30 million and pre-tax earnings were less than $5 million. The capital then required to conduct the business was $8 million. (Modest seasonal debt was also needed for a few months each year.) Consequently, the company was earning 60% pre-tax on invested capital. Two factors helped to minimize the funds required for operations. First, the product was sold for cash, and that eliminated accounts receivable. Second, the production and distribution cycle was short, which minimized inventories. Last year See's sales were $383 million, and pre-tax profits were $82 million. The capital now required to run the business is $40 million. This means we have had to reinvest only $32 million since 1972 to handle the modest physical growth — and somewhat immodest financial growth — of the business. In the meantime pre-tax earnings have totaled $1.35 billion. All of that, except for the $32 million, has been sent to Berkshire (or, in the early years, to Blue Chip). After paying corporate taxes on the profits, we have used the rest to buy other attractive businesses. Just as Adam and Eve kick-started an activity that led to six billion humans, See's has given birth to multiple new streams of cash for us. (The biblical command to "be fruitful and multiply" is one we take seriously at Berkshire.) There aren't many See's in Corporate America. Typically, companies that increase their earnings from $5 million to $82 million require, say, $400 million or so of capital investment to finance their growth. That's because growing businesses have both working capital needs that increase in proportion to sales growth and significant requirements for fixed asset investments. A company that needs large increases in capital to engender its growth may well prove to be a satisfactory investment. There is, to follow through on our example, nothing shabby about earning $82 million pre-tax on $400 million of net tangible assets. But that equation for the owner is vastly different from the See's situation. It's far better to have an ever-increasing stream of earnings with virtually no major capital requirements. Ask Microsoft or Google. One example of good, but far from sensational, business economics is our own FlightSafety. This company delivers benefits to its customers that are the equal of those delivered by any business that I know of. It also possesses a durable competitive advantage: Going to any other flight-training provider than the best is like taking the low bid on a surgical procedure. Nevertheless, this business requires a significant reinvestment of earnings if it is to grow. When we purchased FlightSafety in 1996, its pre-tax operating earnings were $111 million, and its net investment in fixed assets was $570 million. Since our purchase, depreciation charges have totaled $923 million. But capital expenditures have totaled $1.635 billion, most of that for simulators to match the new airplane models that are constantly being introduced. (A simulator can cost us more than $12 million, and we have 273 of them.) Our fixed assets, after depreciation, now amount to $1.079 billion. Pre-tax operating earnings in 2007 were $270 million, a gain of $159 million since 1996. That gain gave us a good, but far from See's-like, return on our incremental investment of $509 million. Consequently, if measured only by economic returns, FlightSafety is an excellent but not extraordinary business. Its put-up-more-to-earn-more experience is that faced by most corporations. For example, our large investment in regulated utilities falls squarely in this category. We will earn considerably more money in this business ten years from now, but we will invest many billions to make it. Now let's move to the gruesome. The worst sort of business is one that grows rapidly, requires significant capital to engender the growth, and then earns little or no money. Think airlines. Here a durable competitive advantage has proven elusive ever since the days of the Wright Brothers. Indeed, if a farsighted capitalist had been present at Kitty Hawk, he would have done his successors a huge favor by shooting Orville down. The airline industry's demand for capital ever since that first flight has been insatiable. Investors have poured money into a bottomless pit, attracted by growth when they should have been repelled by it. And I, to my shame, participated in this foolishness when I had Berkshire buy U.S. Air preferred stock in 1989. As the ink was drying on our check, the company went into a tailspin, and before long our preferred dividend was no longer being paid. But we then got very lucky. In one of the recurrent, but always misguided, bursts of optimism for airlines, we were actually able to sell our shares in 1998 for a hefty gain. In the decade following our sale, the company went bankrupt. Twice. To sum up, think of three types of "savings accounts." The great one pays an extraordinarily high interest rate that will rise as the years pass. The good one pays an attractive rate of interest that will be earned also on deposits that are added. Finally, the gruesome account both pays an inadequate interest rate and requires you to keep adding money at those disappointing returns. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17937-17996

To begin with, I almost blew the See's purchase. The seller was asking $30 million, and I was adamant about not going above $25 million. Fortunately, he caved. Otherwise I would have balked, and that $1.35 billion would have gone to somebody else. About the time of the See's purchase, Tom Murphy, then running Capital Cities Broadcasting, called and offered me the Dallas-Fort Worth NBC station for $35 million. The station came with the Fort Worth paper that Capital Cities was buying, and under the "cross-ownership" rules Murph had to divest it. I knew that TV stations were See's-like businesses that required virtually no capital investment and had excellent prospects for growth. They were simple to run and showered cash on their owners. Moreover, Murph, then as now, was a close friend, a man I admired as an extraordinary manager and outstanding human being. He knew the television business forward and backward and would not have called me unless he felt a purchase was certain to work. In effect Murph whispered "buy" into my ear. But I didn't listen. In 2006, the station earned $73 million pre-tax, bringing its total earnings since I turned down the deal to at least $1 billion — almost all available to its owner for other purposes. Moreover, the property now has a capital value of about $800 million. Why did I say "no"? The only explanation is that my brain had gone on vacation and forgot to notify me. (My behavior resembled that of a politician Molly Ivins once described: "If his I.Q. was any lower, you would have to water him twice a day.") Finally, I made an even worse mistake when I said "yes" to Dexter, a shoe business I bought in 1993 for $433 million in Berkshire stock (25,203 shares of A). What I had assessed as durable competitive advantage vanished within a few years. But that's just the beginning: By using Berkshire stock, I compounded this error hugely. That move made the cost to Berkshire shareholders not $400 million, but rather $3.5 billion. In essence, I gave away 1.6% of a wonderful business — one now valued at $220 billion — to buy a worthless business. To date, Dexter is the worst deal that I've made. But I'll make more mistakes in the future — you can bet on that. A line from Bobby Bare's country song explains what too often happens with acquisitions: "I've never gone to bed with an ugly woman, but I've sure woke up with a few." -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 17998-18015

I should emphasize that we do not measure the progress of our investments by what their market prices do during any given year. Rather, we evaluate their performance by the two methods we apply to the businesses we own. The first test is improvement in earnings, with our making due allowance for industry conditions. The second test, more subjective, is whether their "moats" — a metaphor for the superiorities they possess that make life difficult for their competitors — have widened during the year. All of the "big four" scored positively on that test. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 18127-18131

This does not bother Charlie and me. Indeed, we enjoy such price declines if we have funds available to increase our positions. Long ago, Ben Graham taught me that "Price is what you pay; value is what you get." Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 18385-18387

But enjoyment and utility should be the primary motives for purchase, not profit or refi possibilities. And the home purchased ought to fit the income of the purchaser. The present housing debacle should teach home buyers, lenders, brokers and government some simple lessons that will ensure stability in the future. Home purchases should involve an honest-to-God down payment of at least 10% and monthly payments that can be comfortably handled by the borrower's income. That income should be carefully verified. Putting people into homes, though a desirable goal, shouldn't be our country's primary objective. Keeping them in their homes should be the ambition. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 18545-18550

When faced with large revenue shortfalls, communities that have all of their bonds insured will be more prone to develop "solutions" less favorable to bondholders than those communities that have uninsured bonds held by local banks and residents. Losses in the tax-exempt arena, when they come, are also likely to be highly correlated among issuers. If a few communities stiff their creditors and get away with it, the chance that others will follow in their footsteps will grow. What mayor or city council is going to choose pain to local citizens in the form of major tax increases over pain to a far-away bond insurer? Insuring tax-exempts, therefore, has the look today of a dangerous business — one with similarities, in fact, to the insuring of natural catastrophes. In both cases, a string of loss-free years can be followed by a devastating experience that more than wipes out all earlier profits. We will try, therefore, to proceed carefully in this business, eschewing many classes of bonds that other monolines regularly embrace. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 18604-18611

purchased 15% of Moody's some years ago and have not since bought a share. Moody's, though, has repurchased its own shares and, by late 2008, those repurchases reduced its outstanding shares to the point that our holdings rose above 20%. Burlington Northern has also repurchased shares, but our increase to 20% primarily occurred because we continued to buy this stock. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 18630-18632

Without urging from Charlie or anyone else, I bought a large amount of ConocoPhillips stock when oil and gas prices were near their peak. I in no way anticipated the dramatic fall in energy prices that occurred in the last half of the year. I still believe the odds are good that oil sells far higher in the future than the current $40-$50 price. But so far I have been dead wrong. Even if prices should rise, moreover, the terrible timing of my purchase has cost Berkshire several billion dollars. I made some other already-recognizable errors as well. They were smaller, but unfortunately not that small. During 2008, I spent $244 million for shares of two Irish banks that appeared cheap to me. At yearend we wrote these holdings down to market: $27 million, for an 89% loss. Since then, the two stocks have declined even further. The tennis crowd would call my mistakes "unforced errors." On the plus side last year, we made purchases totaling $14.5 billion in fixed-income securities issued by Wrigley, Goldman Sachs and General Electric. We very much like these commitments, which carry high current yields that, in themselves, make the investments more than satisfactory. But in each of these three purchases, we also acquired a substantial equity participation as a bonus. To fund these large purchases, I had to sell portions of some holdings that I would have preferred to keep (primarily Johnson & Johnson, Procter & Gamble and ConocoPhillips). However, I have pledged — to you, the rating agencies and myself — to always run Berkshire with more than ample cash. We never want to count on the kindness of strangers in order to meet tomorrow's obligations. When forced to choose, I will not trade even a night's sleep for the chance of extra profits. The investment world has gone from underpricing risk to overpricing it. This change has not been minor; the pendulum has covered an extraordinary arc. A few years ago, it would have seemed unthinkable that yields like today's could have been obtained on good-grade municipal or corporate bonds even while risk-free governments offered near-zero returns on short-term bonds and no better than a pittance on long-terms. When the financial history of this decade is written, it will surely speak of the Internet bubble of the late 1990s and the housing bubble of the early 2000s. But the U.S. Treasury bond bubble of late 2008 may be regarded as almost equally extraordinary. Clinging to cash equivalents or long-term government bonds at present yields is almost certainly a terrible policy if continued for long. Holders of these instruments, of course, have felt increasingly comfortable — in fact, almost smug — in following this policy as financial turmoil has mounted. They regard their judgment confirmed when they hear commentators proclaim "cash is king," even though that wonderful cash is earning close to nothing and will surely find its purchasing power eroded over time. Approval, though, is not the goal of investing. In fact, approval is often counter-productive because it sedates the brain and makes it less receptive to new facts or a re-examination of conclusions formed earlier. Beware the investment activity that produces applause; the great moves are usually greeted by yawns. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 18635-18658

So let's postulate that we sell a 100-year $1 billion put option on the S&P 500 at a strike price of 903 (the index's level on 12/31/08). Using the implied volatility assumption for long-dated contracts that we do, and combining that with appropriate interest and dividend assumptions, we would find the "proper" Black-Scholes premium for this contract to be $2.5 million. To judge the rationality of that premium, we need to assess whether the S&P will be valued a century from now at less than today. Certainly the dollar will then be worth a small fraction of its present value (at only 2% inflation it will be worth roughly 14¢). So that will be a factor pushing the stated value of the index higher. Far more important, however, is that one hundred years of retained earnings will hugely increase the value of most of the companies in the index. In the 20th Century, the Dow-Jones Industrial Average increased by about 175-fold, mainly because of this retained-earnings factor. Considering everything, I believe the probability of a decline in the index over a one-hundred-year period to be far less than 1%. But let's use that figure and also assume that the most likely decline — should one occur — is 50%. Under these assumptions, the mathematical expectation of loss on our contract would be $5 million ($1 billion X 1% X 50%). -- Warren Buffett, Berkshire

Hathaway Letters to Shareholders, 2013, loc. 18767-18777

Our metrics for evaluating our managerial performance are displayed on the facing page. From the start, Charlie and I have believed in having a rational and unbending standard for measuring what we have — or have not — accomplished. That keeps us from the temptation of seeing where the arrow of performance lands and then painting the bull's eye around it. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 18866-18868

Long ago, Charlie laid out his strongest ambition: "All I want to know is where I'm going to die, so I'll never go there." That bit of wisdom was inspired by Jacobi, the great Prussian mathematician, who counseled "Invert, always invert" as an aid to solving difficult problems. (I can report as well that this inversion approach works on a less lofty level: Sing a country song in reverse, and you will quickly recover your car, house and wife.) Here are a few examples of how we apply Charlie's thinking at Berkshire: Charlie and I avoid businesses whose futures we can't evaluate, no matter how exciting their products may be. In the past, it required no brilliance for people to foresee the fabulous growth that awaited such industries as autos (in 1910), aircraft (in 1930) and television sets (in 1950). But the future then also included competitive dynamics that would decimate almost all of the companies entering those industries. Even the survivors tended to come away bleeding. Just because Charlie and I can clearly see dramatic growth ahead for an industry does not mean we can judge what its profit margins and returns on capital will be as a host of competitors battle for supremacy. At Berkshire we will stick with businesses whose profit picture for decades to come seems reasonably predictable. Even then, we will make plenty of mistakes. We will never become dependent on the kindness of strangers. Too-big-to-fail is not a fallback position at Berkshire. Instead, we will always arrange our affairs so that any requirements for cash we may conceivably have will be dwarfed by our own liquidity. Moreover, that liquidity will be constantly refreshed by a gusher of earnings from our many and diverse businesses. When the financial system went into cardiac arrest in September 2008, Berkshire was a supplier of liquidity and capital to the system, not a supplicant. At the very peak of the crisis, we poured $15.5 billion into a business world that could otherwise look only to the federal government for help. Of that, $9 billion went to bolster capital at three highly-regarded and previously-secure American businesses that needed — without delay — our tangible vote of confidence. The remaining $6.5 billion satisfied our commitment to help fund the purchase of Wrigley, a deal that was completed without pause while, elsewhere, panic reigned. We pay a steep price to maintain our premier financial strength. The $20 billion-plus of cash-equivalent assets that we customarily hold is earning a pittance at present. But we sleep well. We tend to let our many subsidiaries operate on their own, without our supervising and monitoring them to any degree. That means we are sometimes late in spotting management problems and that both operating and capital decisions are occasionally made with which Charlie and I would have disagreed had we been consulted. Most of our managers, however, use the independence we grant them magnificently, rewarding our confidence by maintaining an owner-oriented attitude that is invaluable and too seldom found in huge organizations. We would rather suffer the visible costs of a few bad decisions than incur the many invisible costs that come from decisions made too slowly — or not at all — because of a stifling bureaucracy. With our acquisition of BNSF, we now have about 257,000 employees and literally hundreds of different operating units. We hope to have many more of each. But we will never allow Berkshire to become some monolith that is overrun with committees, budget presentations and multiple layers of management. Instead, we plan to operate as a collection of separately-managed medium-sized and large businesses, most of whose decision-making occurs at the operating level. Charlie and I will limit ourselves to allocating capital, controlling enterprise risk, choosing managers and setting their compensation. We make no attempt to woo Wall Street. Investors who buy and sell based upon media or analyst commentary are not for us. Instead we want partners who join us at Berkshire because they wish to make a long-term investment in a business they themselves understand and because it's one that follows policies with which they concur. If Charlie and I were to go into a small venture with a few partners, we would seek individuals in sync with us, knowing that common goals and a shared destiny make for a happy business "marriage" between owners and managers. Scaling up to giant size doesn't change that truth. To build a compatible shareholder population, we try to communicate with our owners directly and informatively. Our goal is to tell you what we would like to know if our positions were reversed. Additionally, we try to post our quarterly and annual financial information on the Internet early on weekends, thereby giving you and other investors plenty of time during a non-trading period to digest just what has happened at our multi-faceted enterprise. (Occasionally, SEC deadlines force a non-Friday disclosure.) These matters simply can't be adequately summarized in a few paragraphs, nor do they lend themselves to the kind of catchy headline that journalists sometimes seek. Last year we saw, in one instance, how sound-bite reporting can go wrong. Among the 12,830 words in the annual letter was this sentence: "We are certain, for example, that the economy will be in shambles throughout 2009 — and probably well beyond — but that conclusion does not tell us whether the market will rise or fall." Many news organizations reported — indeed, blared — the first part of the sentence while making no mention whatsoever of its ending. I regard this as terrible journalism: Misinformed readers or viewers may well have thought that Charlie and I were forecasting bad things for the stock market, though we had not only in that sentence, but also elsewhere, made it clear we weren't predicting the market at all. Any investors who were misled by the sensationalists paid a big price: The Dow closed the day of the letter at 7,063 and finished the year at 10,428. Given a few experiences we've had like that, you can understand why I prefer that our communications with you remain as direct and unabridged as possible. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 18894-18937

Ajit's business is just the opposite of GEICO's. At that company, we have millions of small policies that largely renew year after year. Ajit writes relatively few policies, and the mix changes significantly from year to year. Throughout the world, he is known as the man to call when something both very large and unusual needs to be insured. If Charlie, I and Ajit are ever in a sinking boat — and you can only save one of us — swim to Ajit. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 18987-18990

In earlier days, Charlie and I shunned capital-intensive businesses such as public utilities. Indeed, the best businesses by far for owners continue to be those that have high returns on capital and that require little incremental investment to grow. We are fortunate to own a number of such businesses, and we would love to buy more. Anticipating, however, that Berkshire will generate ever-increasing amounts of cash, we are today quite willing to enter businesses that regularly require large capital expenditures. We expect only that these businesses have reasonable expectations of earning decent returns on the incremental sums they invest. If our expectations are met — and we believe that they will be — Berkshire's ever-growing collection of good to great businesses should produce above-average, though certainly not spectacular, returns in the decades ahead. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 19031-19037

NetJets' business operation, however, has been another story. In the eleven years that we have owned the company, it has recorded an aggregate pre-tax loss of $157 million. Moreover, the company's debt has soared from $102 million at the time of purchase to $1.9 billion in April of last year. Without Berkshire's guarantee of this debt, NetJets would have been out of business. It's clear that I failed you in letting NetJets descend into this condition. But, luckily, I have been bailed out. Dave Sokol, the enormously talented builder and operator of MidAmerican Energy, became CEO of NetJets in August. His leadership has been transforming: Debt has already been reduced to $1.4 billion, and, after suffering a staggering loss of $711 million in 2009, the company is now solidly profitable. Most important, none of the changes wrought by Dave have in any way undercut the top-of-the-line standards for safety and service that Rich Santulli, NetJets' previous CEO and the father of the fractional-ownership industry, insisted upon. Dave and I have the strongest possible personal interest in maintaining these standards because we and our families use NetJets for almost all of our flying, as do many of our directors and managers. None of us are assigned special planes nor crews. We receive exactly the same treatment as any other owner, meaning we pay the same prices as everyone else does when we are using our personal contracts. In short, we eat our own cooking. In the aviation business, no other testimonial means more. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 19070-19080

There were three ways to cure this overhang: (1) blow up a lot of houses, a tactic similar to the destruction of autos that occurred with the "cash-for-clunkers" program; (2) speed up household formations by, say, encouraging teenagers to cohabitate, a program not likely to suffer from a lack of volunteers or; (3) reduce new housing starts to a number far below the rate of household formations. Our country has wisely selected the third option, which means that within a year or so residential housing problems should largely be behind us, the exceptions being only high-value houses and those in certain localities where overbuilding was particularly egregious. Prices will remain far below "bubble" levels, of course, but for every seller (or lender) hurt by this there will be a buyer who benefits. Indeed, many families that couldn't afford to buy an appropriate home a few years ago now find it well within their means because the bubble burst. The second reason that manufactured housing is troubled is specific to the industry: the punitive differential in mortgage rates between factory-built homes and site-built homes. Before you read further, let me underscore the obvious: Berkshire has a dog in this fight, and you should therefore assess the commentary that follows with special care. That warning made, however, let me explain why the rate differential causes problems for both large numbers of lower-income Americans and Clayton. The residential mortgage market is shaped by government rules that are expressed by FHA, Freddie Mac and Fannie Mae. Their lending standards are all-powerful because the mortgages they insure can typically be securitized and turned into what, in effect, is an obligation of the U.S. government. Currently buyers of conventional site-built homes who qualify for these guarantees can obtain a 30-year loan at about 5¼%. In addition, these are mortgages that have recently been purchased in massive amounts by the Federal Reserve, an action that also helped to keep rates at bargain-basement levels. In contrast, very few factory-built homes qualify for agency-insured mortgages. Therefore, a meritorious buyer of a factory-built home must pay about 9% on his loan. For the all-cash buyer, Clayton's homes offer terrific value. If the buyer needs mortgage financing, however — and, of course, most buyers do — the difference in financing costs too often negates the attractive price of a factory-built home. Last year I told you why our buyers — generally people with low incomes — performed so well as credit risks. Their attitude was all-important: They signed up to live in the home, not resell or refinance it. Consequently, our buyers usually took out loans with payments geared to their verified incomes (we weren't making "liar's loans") and looked forward to the day they could burn their mortgage. If they lost their jobs, had health problems or got divorced, we could of course expect defaults. But they seldom walked away simply because house values had fallen. Even today, though job-loss troubles have grown, Clayton's delinquencies and defaults remain reasonable and will not cause us significant problems. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 19088-19110

Charlie and I believe that a CEO must not delegate risk control. It's simply too important. At Berkshire, I both initiate and monitor every derivatives contract on our books, with the exception of operations-related contracts at a few of our subsidiaries, such as MidAmerican, and the minor runoff contracts at General Re. If Berkshire ever gets in trouble, it will be my fault. It will not be because of misjudgments made by a Risk Committee or Chief Risk Officer. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 19166-19170

In my view a board of directors of a huge financial institution is derelict if it does not insist that its CEO bear full responsibility for risk control. If he's incapable of handling that job, he should look for other employment. And if he fails at it — with the government thereupon required to step in with funds or guarantees — the financial consequences for him and his board should be severe. It has not been shareholders who have botched the operations of some of our country's largest financial institutions. Yet they have borne the burden, with 90% or more of the value of their holdings wiped out in most cases of failure. Collectively, they have lost more than $500 billion in just the four largest financial fiascos of the last two years. To say these owners have been "bailed-out" is to make a mockery of the term. The CEOs and directors of the failed companies, however, have largely gone unscathed. Their fortunes may have been diminished by the disasters they oversaw, but they still live in grand style. It is the behavior of these CEOs and directors that needs to be changed: If their institutions and the country are harmed by their recklessness, they should pay a heavy price — one not reimbursable by the companies they've damaged nor by insurance. CEOs and, in many cases, directors have long benefitted from oversized financial carrots; some meaningful sticks now need to be part of their employment picture as well. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 19170-19180

When stock is the currency being contemplated in an acquisition and when directors are hearing from an advisor, it appears to me that there is only one way to get a rational and balanced discussion. Directors should hire a second advisor to make the case against the proposed acquisition, with its fee contingent on the deal not going through. Absent this drastic remedy, our recommendation in respect to the use of advisors remains: "Don't ask the barber whether you need a haircut." -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 19213-19217

"After the merger," he in effect said, perhaps using words that were phrased more diplomatically than these, "I'm going to be a large shareholder of your bank, and it will represent a huge portion of my net worth. You have to promise me, therefore, that you'll never again do a deal this dumb." -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 19227-19229

Over time, you can expect our stock price to move in rough tandem with Berkshire's investments and earnings. Market price and intrinsic value often follow very different paths — sometimes for extended periods — but eventually they meet. There is a third, more subjective, element to an intrinsic value calculation that can be either positive or negative: the efficacy with which retained earnings will be deployed in the future. We, as well as many other businesses, are likely to retain earnings over the next decade that will equal, or even exceed, the capital we presently employ. Some companies will turn these retained dollars into fifty-cent pieces, others into two-dollar bills. This "what-will-they-do-with-the-money" factor must always be evaluated along with the "what-do-we-have-now" calculation in order for us, or anybody, to arrive at a sensible estimate of a company's intrinsic value. That's because an outside investor stands by helplessly as management reinvests his share of the company's earnings. If a CEO can be expected to do this job well, the reinvestment prospects add to the company's current value; if the CEO's talents or motives are suspect, today's value must be discounted. The difference in outcome can be huge. A dollar of then-value in the hands of Sears Roebuck's or Montgomery Ward's CEOs in the late 1960s had a far different destiny than did a dollar entrusted to Sam Walton. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 19370-19380

First, we possess a cadre of truly skilled managers who have an unusual commitment to their own operations and to Berkshire. Many of our CEOs are independently wealthy and work only because they love what they do. They are volunteers, not mercenaries. Because no one can offer them a job they would enjoy more, they can't be lured away. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 19383-19385

They are not subjected to meetings at headquarters nor financing worries nor Wall Street harassment. They simply get a letter from me every two years (reproduced at the end of this letter) and call me when they wish. And their wishes do differ: There are managers to whom I have not talked in the last year, while there is one with whom I talk almost daily. Our trust is in people rather than process. A "hire well, manage little" code suits both them and me. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 19386-19389

When I took control of Berkshire in 1965, I didn't exploit this advantage. Berkshire was then only in textiles, where it had in the previous decade lost significant money. The dumbest thing I could have done was to pursue "opportunities" to improve and expand the existing textile operation — so for years that's exactly what I did. And then, in a final burst of brilliance, I went out and bought another textile company. Aaaaaaargh -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 19399-19402

That was my lucky moment. During the next four hours, “Davy” gave me an education about both insurance and GEICO. It was the beginning of a wonderful friendship. Soon thereafter, I graduated from Columbia and became a stock salesman in Omaha. GEICO, of course, was my prime recommendation, which got me off to a great start with dozens of customers. GEICO also jump-started my net worth because, soon after meeting Davy, I made the stock 75% of my $9,800 investment portfolio. (Even so, I felt over-diversified.) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 19433-19436

We then purchased the remaining 50% of GEICO at the beginning of 1996, which spurred Davy, at 95, to make a video tape saying how happy he was that his beloved GEICO would permanently reside with Berkshire. (He also playfully concluded with, “Next time, Warren, please make an appointment.”) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 19440-19442

At bottom, a sound insurance operation requires four disciplines: (1) An understanding of all exposures that might cause a policy to incur losses; (2) A conservative evaluation of the likelihood of any exposure actually causing a loss and the probable cost if it does; (3) The setting of a premium that will deliver a profit, on average, after both prospective loss costs and operating expenses are covered; and (4) The willingness to walk away if the appropriate premium can’t be obtained. Many insurers pass the first three tests and flunk the fourth. The urgings of Wall Street, pressures from the agency force and brokers, or simply a refusal by a testosterone-driven CEO to accept shrinking volumes has led too many insurers to write business at inadequate prices. “The other guy is doing it so we must as well” spells trouble in any business, but none more so than insurance. Tad has observed all four of the insurance commandments, and it shows in his results. General Re’s huge float has been better than cost-free under his leadership, and we expect that, on average, it will continue to be. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 19492-19500

Home ownership makes sense for most Americans, particularly at today’s lower prices and bargain interest rates. All things considered, the third best investment I ever made was the purchase of my home, though I would have made far more money had I instead rented and used the purchase money to buy stocks. (The two best investments were wedding rings.) For the $31,500 I paid for our house, my family and I gained 52 years of terrific memories with more to come. But a house can be a nightmare if the buyer’s eyes are bigger than his wallet and if a lender — often protected by a government guarantee — facilitates his fantasy. Our country’s social goal should not be to put families into the house of their dreams, but rather to put them into a house they can afford. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 19605-19610

When Charlie and I met Todd Combs, we knew he fit our requirements. Todd, as was the case with Lou, will be paid a salary plus a contingent payment based on his performance relative to the S&P. We have arrangements in place for deferrals and carryforwards that will prevent see-saw performance being met by undeserved payments. The hedge-fund world has witnessed some terrible behavior by general partners who have received huge payouts on the upside and who then, when bad results occurred, have walked away rich, with their limited partners losing back their earlier gains. Sometimes these same general partners thereafter quickly started another fund so that they could immediately participate in future profits without having to overcome their past losses. Investors who put money with such managers should be labeled patsies, not partners. As long as I am CEO, I will continue to manage the great majority of Berkshire’s holdings, both bonds and equities. Todd initially will manage funds in the range of one to three billion dollars, an amount he can reset annually. His focus will be equities but he is not restricted to that form of investment. (Fund consultants like to require style boxes such as “long-short,” “macro,” “international equities.” At Berkshire our only style box is “smart.”) Over time, we may add one or two investment managers if we find the right individuals. Should we do that, we will probably have 80% of each manager’s performance compensation be dependent on his or her own portfolio and 20% on that of the other manager(s). We want a compensation system that pays off big for individual success but that also fosters cooperation, not competition. When Charlie and I are no longer around, our investment manager(s) will have responsibility for the entire portfolio in a manner then set by the CEO and Board of Directors. Because good investors bring a useful perspective to the purchase of businesses, we would expect them to be consulted — but not to have a vote — on the wisdom of possible acquisitions. In the end, of course, the Board will make the call on any major acquisition. One footnote: When we issued a press release about Todd’s joining us, a number of commentators pointed out that he was “little-known” and expressed puzzlement that we didn’t seek a “big-name.” I wonder how many of them would have known of Lou in 1979, Ajit in 1985, or, for that matter, Charlie in 1959. Our goal was to find a 2-year-old Secretariat, not a 10-year-old Seabiscuit. (Whoops — that may not be the smartest metaphor for an 80-year-old CEO to use.) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 19652-19670

You should also understand that we get paid up-front when we enter into the contracts and therefore run no counterparty risk. That’s important. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 19676-19677

The fundamental principle of auto racing is that to finish first, you must first finish. That dictum is equally applicable to business and guides our every action at Berkshire. Unquestionably, some people have become very rich through the use of borrowed money. However, that’s also been a way to get very poor. When leverage works, it magnifies your gains. Your spouse thinks you’re clever, and your neighbors get envious. But leverage is addictive. Once having profited from its wonders, very few people retreat to more conservative practices. And as we all learned in third grade — and some relearned in 2008 — any series of positive numbers, however impressive the numbers may be, evaporates when multiplied by a single zero. History tells us that leverage all too often produces zeroes, even when it is employed by very smart people. Leverage, of course, can be lethal to businesses as well. Companies with large debts often assume that these obligations can be refinanced as they mature. That assumption is usually valid. Occasionally, though, either because of company-specific problems or a worldwide shortage of credit, maturities must actually be met by payment. For that, only cash will do the job. Borrowers then learn that credit is like oxygen. When either is abundant, its presence goes unnoticed. When either is missing, that’s all that is noticed. Even a short absence of credit can bring a company to its knees. In September 2008, in fact, its overnight disappearance in many sectors of the economy came dangerously close to bringing our entire country to its knees. Charlie and I have no interest in any activity that could pose the slightest threat to Berkshire’s wellbeing. (With our having a combined age of 167, starting over is not on our bucket list.) We are forever conscious of the fact that you, our partners, have entrusted us with what in many cases is a major portion of your savings. In addition, important philanthropy is dependent on our prudence. Finally, many disabled victims of accidents caused by our insureds are counting on us to deliver sums payable decades from now. It would be irresponsible for us to risk what all these constituencies need just to pursue a few points of extra return. A little personal history may partially explain our extreme aversion to financial adventurism. I didn’t meet Charlie until he was 35, though he grew up within 100 yards of where I have lived for 52 years and also attended the same inner-city public high school in Omaha from which my father, wife, children and two grandchildren graduated. Charlie and I did, however, both work as young boys at my grandfather’s grocery store, though our periods of employment were separated by about five years. My grandfather’s name was Ernest, and perhaps no man was more aptly named. No one worked for Ernest, even as a stock boy, without being shaped by the experience. On the facing page you can read a letter sent in 1939 by Ernest to his youngest son, my Uncle Fred. Similar letters went to his other four children. I still have the letter sent to my Aunt Alice, which I found — along with $1,000 of cash — when, as executor of her estate, I opened her safe deposit box in 1970. Ernest never went to business school — he never in fact finished high school — but he understood the importance of liquidity as a condition for assured survival. At Berkshire, we have taken his $1,000 solution a bit further and have pledged that we will hold at least $10 billion of cash, excluding that held at our regulated utility and railroad businesses. Because of that commitment, we customarily keep at least $20 billion on hand so that we can both withstand unprecedented insurance losses (our largest to date having been about $3 billion from Katrina, the insurance industry’s most expensive catastrophe) and quickly seize acquisition or investment opportunities, even during times of financial turmoil. We keep our cash largely in U.S. Treasury bills and avoid other short-term securities yielding a few more basis points, a policy we adhered to long before the frailties of commercial paper and money market funds became apparent in September 2008. We agree with investment writer Ray DeVoe's observation, "More money has been lost reaching for yield than at the point of a gun." At Berkshire, we don't rely on bank lines, and we don't enter into contracts that could require postings of collateral except for amounts that are tiny in relation to our liquid assets. Furthermore, not a dime of cash has left Berkshire for dividends or share repurchases during the past 40 years. Instead, we have retained all of our earnings to strengthen our business, a reinforcement now running about $1 billion per month. Our net worth has thus increased from $48 million to $157 billion during those four decades and our intrinsic value has grown far more. No other American corporation has come close to building up its financial strength in this unrelenting way. By being so cautious in respect to leverage, we penalize our returns by a minor amount. Having loads of liquidity, though, lets us sleep well. Moreover, during the episodes of financial chaos that occasionally erupt in our economy, we will be equipped both financially and emotionally to play offense while others scramble for survival. That's what allowed us to invest $15.6 billion in 25 days of panic following the Lehman bankruptcy in 2008. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 19744-19782

P.S. Another minor request: Please turn down all proposals for me to speak, make contributions, intercede with the Gates Foundation, etc. Sometimes these requests for you to act as intermediary will be accompanied by "It can't hurt to ask." It will be easier for both of us if you just say "no." As an added favor, don't suggest that they instead write or call me. Multiply 76 businesses by the periodic "I think he'll be interested in this one" and you can understand why it is better to say no firmly and immediately. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 19876-19880

Charlie and I favor repurchases when two conditions are met: first, a company has ample funds to take care of the operational and liquidity needs of its business; second, its stock is selling at a material discount to the company's intrinsic business value, conservatively calculated. We have witnessed many bouts of repurchasing that failed our second test. Sometimes, of course, infractions — even serious ones — are innocent; many CEOs never stop believing their stock is cheap. In other instances, a less benign conclusion seems warranted. It doesn't suffice to say that repurchases are being made to offset the dilution from stock issuances or simply because a company has excess cash. Continuing shareholders are hurt unless shares are purchased below intrinsic value. The first law of capital allocation — whether the money is slated for acquisitions or share repurchases — is that what is smart at one price is dumb at another. (One CEO who always stresses the price/value factor in repurchase decisions is Jamie Dimon at J.P. Morgan; I recommend that you read his annual letter.) Charlie and I have mixed emotions when Berkshire shares sell well below intrinsic value. We like making money for continuing shareholders, and there is no surer way to do that than by buying an asset — our own stock — that we know to be worth at least x for less than that — for .9x, .8x or even lower. (As one of our directors says, it's like shooting fish in a barrel, after the barrel has been drained and the fish have quit flopping.) Nevertheless, we don't enjoy cashing out partners at a discount, even though our doing so may give the selling shareholders a slightly higher price than they would receive if our bid was absent. When we are buying, therefore, we want those exiting partners to be fully informed about the value of the assets they are selling. At our limit price of 110% of book value, repurchases clearly increase Berkshire's per-share intrinsic value. And the more and the cheaper we buy, the greater the gain for continuing shareholders. Therefore, if given the opportunity, we will likely repurchase stock aggressively at our price limit or lower. You should know, however, that we have no interest in supporting the stock and that our bids will fade in particularly weak markets. Nor will we buy shares if our cash-equivalent holdings are below $20 billion. At Berkshire, financial strength that is unquestionable takes precedence over all else. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 19978-19995

Then I read Chapter Eight of Ben Graham's The Intelligent Investor, the chapter dealing with how investors should view fluctuations in stock prices. Immediately the scales fell from my eyes, and low prices became my friend. Picking up that book was one of the luckiest moments in my life. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 20020-20022

At the core of the folly was the almost universal belief that the value of houses was certain to increase over time and that any dips would be inconsequential. The acceptance of this premise justified almost any price and practice in housing transactions. Homeowners everywhere felt richer and rushed to "monetize" the increased value of their homes by refinancings. These massive cash infusions fueled a consumption binge throughout our economy. It all seemed great fun while it lasted. (A largely unnoted fact: Large numbers of people who have "lost" their house through foreclosure have actually realized a profit because they carried out refinancings earlier that gave them cash in excess of their cost. In these cases, the evicted homeowner was the winner, and the victim was the lender.) -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 20236-20242

We shun contracts of any type that could require the instant posting of collateral. The possibility of some sudden and huge posting requirement — arising from an out-of-the-blue event such as a worldwide financial panic or massive terrorist attack — is inconsistent with our primary objectives of redundant liquidity and unquestioned financial strength. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 20263-20265

The riskiness of an investment is not measured by beta (a Wall Street term encompassing volatility and often used in measuring risk) but rather by the probability — the reasoned probability — of that investment causing its owner a loss of purchasing-power over his contemplated holding period. Assets can fluctuate greatly in price and not be risky as long as they are reasonably certain to deliver increased purchasing power over their holding period. And as we will see, a non-fluctuating asset can be laden with risk. Investment possibilities are both many and varied. There are three major categories, however, and it's important to understand the characteristics of each. So let's survey the field. Investments that are denominated in a given currency include money-market funds, bonds, mortgages, bank deposits, and other instruments. Most of these currency-based investments are thought of as "safe." In truth they are among the most dangerous of assets. Their beta may be zero, but their risk is huge. Over the past century these instruments have destroyed the purchasing power of investors in many countries, even as the holders continued to receive timely payments of interest and principal. This ugly result, moreover, will forever recur. Governments determine the ultimate value of money, and systemic forces will sometimes cause them to gravitate to policies that produce inflation. From time to time such policies spin out of control. Even in the U.S., where the wish for a stable currency is strong, the dollar has fallen a staggering 86% in value since 1965, when I took over management of Berkshire. It takes no less than $7 today to buy what $1 did at that time. Consequently, a tax-free institution would have needed 4.3% interest annually from bond investments over that period to simply maintain its purchasing power. Its managers would have been kidding themselves if they thought of any portion of that interest as "income." For tax-paying investors like you and me, the picture has been far worse. During the same 47-year period, continuous rolling of U.S. Treasury bills produced 5.7% annually. That sounds satisfactory. But if an individual investor paid personal income taxes at a rate averaging 25%, this 5.7% return would have yielded nothing in the way of real income. This investor's visible income tax would have stripped him of 1.4 points of the stated yield, and the invisible inflation tax would have devoured the remaining 4.3 points. It's noteworthy that the implicit inflation "tax" was more than triple the explicit income tax that our investor probably thought of as his main burden. "In God We Trust" may be imprinted on our currency, but the hand that activates our government's printing press has been all too human. High interest rates, of course, can compensate purchasers for the inflation risk they face with currency-based investments — and indeed, rates in the early 1980s did that job nicely. Current rates, however, do not come close to offsetting the purchasing-power risk that investors assume. Right now bonds should come with a warning label. Under today's conditions, therefore, I do not like currency-based investments. Even so, Berkshire holds significant amounts of them, primarily of the short-term variety. At Berkshire the need for ample liquidity occupies center stage and will never be slighted, however inadequate rates may be. Accommodating this need, we primarily hold U.S. Treasury bills, the only investment that can be counted on for liquidity under the most chaotic of economic conditions. Our working level for liquidity is $20 billion; $10 billion is our absolute minimum. Beyond the requirements that liquidity and regulators impose on us, we will purchase currency-related securities only if they offer the possibility of unusual gain — either because a particular credit is mispriced, as can occur in periodic junk-bond debacles, or because rates rise to a level that offers the possibility of realizing substantial capital gains on high-grade bonds when rates fall. Though we've exploited both opportunities in the past — and may do so again — we are now 180 degrees removed from such prospects. Today, a wry comment that Wall Streeter Shelby Cullom Davis made long ago seems apt: "Bonds promoted as offering risk-free returns are now priced to deliver return-free risk." The second major category of investments involves assets that will never produce anything, but that are purchased in the buyer's hope that someone else — who also knows that the assets will be forever unproductive — will pay more for them in the future. Tulips, of all things, briefly became a favorite of such buyers in the 17th century. This type of investment requires an expanding pool of buyers, who, in turn, are enticed because they believe the buying pool will expand still further. Owners are not inspired by what the asset itself can produce — it will remain lifeless forever — but rather by the belief that others will desire it even more avidly in the future. The major asset in this category is gold, currently a huge favorite of investors who fear almost all other assets, especially paper money (of whose value, as noted, they are right to be fearful). Gold, however, has two significant shortcomings, being neither of much use nor procreative. True, gold has some industrial and decorative utility, but the demand for these purposes is both limited and incapable of soaking up new production. Meanwhile, if you own one ounce of gold for an eternity, you will still own one ounce at its end. What motivates most gold purchasers is their belief that the ranks of the fearful will grow. During the past decade that belief has proved correct. Beyond that, the rising price has on its own generated additional buying enthusiasm, attracting purchasers who see the rise as validating an investment thesis. As "bandwagon" investors join any party, they create their own truth — for a while. Over the past 15 years, both Internet stocks and houses have demonstrated the extraordinary excesses that can be created by combining an initially sensible thesis with well-publicized rising prices. In these bubbles, an army of originally skeptical investors succumbed to the "proof" delivered by the market, and the pool of buyers — for a time — expanded sufficiently to keep the bandwagon rolling. But bubbles blown large enough inevitably pop. And then the old proverb is confirmed once again: "What the wise man does in the beginning, the fool does in the end." Today the world's gold stock is about 170,000 metric tons. If all of this gold were melded together, it would form a cube of about 68 feet per side. (Picture it fitting comfortably within a baseball infield.) At $1,750 per ounce — gold's price as I write this — its value would be $9.6 trillion. Call this cube pile A. Let's now create a pile B costing an equal amount. For that, we could buy all U.S. cropland (400 million acres with output of about $200 billion annually), plus 16 Exxon Mobils (the world's most profitable company, one earning more than $40 billion annually). After these purchases, we would have about $1 trillion left over for walking-around money (no sense feeling strapped after this buying binge). Can you imagine an investor with $9.6 trillion selecting pile A over pile B? Beyond the staggering valuation given the existing stock of gold, current prices make today's annual production of gold command about $160 billion. Buyers — whether jewelry and industrial users, frightened individuals, or speculators — must continually absorb this additional supply to merely maintain an equilibrium at present prices. A century from now the 400 million acres of farmland will have produced staggering amounts of corn, wheat, cotton, and other crops — and will continue to produce that valuable bounty, whatever the currency may be. Exxon Mobil will probably have delivered trillions of dollars in dividends to its owners and will also hold assets worth many more trillions (and, remember, you get 16 Exxons). The 170,000 tons of gold will be unchanged in size and still incapable of producing anything. You can fondle the cube, but it will not respond. Admittedly, when people a century from now are fearful, it's likely many will still rush to gold. I'm confident, however, that the $9.6 trillion current valuation of pile A will compound over the century at a rate far inferior to that achieved by pile B. Our first two categories enjoy maximum popularity at peaks of fear: Terror over economic collapse drives individuals to currency-based assets, most particularly U.S. obligations, and fear of currency collapse fosters movement to sterile assets such as gold. We heard "cash is king" in late 2008, just when cash should have been deployed rather than held. Similarly, we heard "cash is trash" in the early 1980s just when fixed-dollar investments were at their most attractive level in memory. On those occasions, investors who required a supportive crowd paid dearly for that comfort. My own preference — and you knew this was coming — is our third category: investment in productive assets, whether businesses, farms, or real estate. Ideally, these assets should have the ability in inflationary times to deliver output that will retain its purchasing-power value while requiring a minimum of new capital investment. Farms, real estate, and many businesses such as Coca-Cola, IBM and our own See's Candy meet that double-barreled test. Certain other companies — think of our regulated utilities, for example — fail it because inflation places heavy capital requirements on them. To earn more, their owners must invest more. Even so, these investments will remain superior to nonproductive or currency-based assets. Whether the currency a century from now is based on gold, seashells, shark teeth, or a piece of paper (as today), people will be willing to exchange a couple of minutes of their daily labor for a Coca-Cola or some See's peanut brittle. In the future the U.S. population will move more goods, consume more food, and require more living space than it does now. People will forever exchange what they produce for what others produce. Our country's businesses will continue to efficiently deliver goods and services wanted by our citizens. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 20278-20351

A further unpleasant reality adds to the industry's dim prospects: Insurance earnings are now benefitting from "legacy" bond portfolios that deliver much higher yields than will be available when funds are reinvested during the next few years — and perhaps for many years beyond that. Today's bond portfolios are, in effect, wasting assets. Earnings of insurers will be hurt in a significant way as bonds mature and are rolled over. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 20573-20576

Last year GEICO enjoyed a meaningful increase in both the renewal rate for existing policyholders ("persistency") and in the percentage of rate quotations that resulted in sales ("closures"). Big dollars ride on those two factors: A sustained gain in persistency of a bare one percentage point increases intrinsic value by more than $1 billion. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 20603-20605

The earnings that Wells Fargo reports are heavily burdened by an "amortization of core deposits" charge, the implication being that these deposits are disappearing at a fairly rapid clip. Yet core deposits regularly increase. The charge last year was about $1.5 billion. In no sense, except GAAP accounting, is this whopping charge an expense. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 20668-20670

The Clash of the Cultures by Jack Bogle and Laura Rittenhouse's Investing Between the Lines. Should you need to ship your book purchases, a shipping service will be available nearby. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 20937-20938

In 1986, I purchased a 400-acre farm, located 50 miles north of Omaha, from the FDIC. It cost me $280,000, considerably less than what a failed bank had lent against the farm a few years earlier. I knew nothing about operating a farm. But I have a son who loves farming and I learned from him both how many bushels of corn and soybeans the farm would produce and what the operating expenses would be. From these estimates, I calculated the normalized return from the farm to then be about 10%. I also thought it was likely that productivity would improve over time and that crop prices would move higher as well. Both expectations proved out. I needed no unusual knowledge or intelligence to conclude that the investment had no downside and potentially had substantial upside. There would, of course, be the occasional bad crop and prices would sometimes disappoint. But so what? There would be some unusually good years as well, and I would never be under any pressure to sell the property. Now, 28 years later, the farm has tripled its earnings and is worth five times or more what I paid. I still know nothing about farming and recently made just my second visit to the farm. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 21336-21344

You don't need to be an expert in order to achieve satisfactory investment returns. But if you aren't, you must recognize your limitations and follow a course certain to work reasonably well. Keep things simple and don't swing for the fences. When promised quick profits, respond with a quick "no." Focus on the future productivity of the asset you are considering. If you don't feel comfortable making a rough estimate of the asset's future earnings, just forget it and move on. No one has the ability to evaluate every investment possibility. But omniscience isn't necessary; you only need to understand the actions you undertake. If you instead focus on the prospective price change of a contemplated purchase, you are speculating. There is nothing improper about that. I know, however, that I am unable to speculate successfully, and I am skeptical of those who claim sustained success at doing so. Half of all coin-flippers will win their first toss; none of those winners has an expectation of profit if he continues to play the game. And the fact that a given asset has appreciated in the recent past is never a reason to buy it. With my two small investments, I thought only of what the properties would produce and cared not at all about their daily valuations. Games are won by players who focus on the playing field — not by those whose eyes are glued to the scoreboard. If you can enjoy Saturdays and Sundays without looking at stock prices, give it a try on weekdays. Forming macro opinions or listening to the macro or market predictions of others is a waste of time. Indeed, it is dangerous because it may blur your vision of the facts that are truly important. (When I hear TV commentators glibly opine on what the market will do next, I am reminded of Mickey Mantle's scathing comment: "You don't know how easy this game is until you get into that broadcasting booth.") My two purchases were made in 1986 and 1993. What the economy, interest rates, or the stock market might do in the years immediately following — 1987 and 1994 — was of no importance to me in making those investments. I can't remember what the headlines or pundits were saying at the time. Whatever the chatter, corn would keep growing in Nebraska and students would flock to NYU. There is one major difference between my two small investments and an investment in stocks. Stocks provide you minute-to-minute valuations for your holdings whereas I have yet to see a quotation for either my farm or the New York real estate. It should be an enormous advantage for investors in stocks to have those wildly fluctuating valuations placed on their holdings — and for some investors, it is. After all, if a moody fellow with a farm bordering my property yelled out a price every day to me at which he would either buy my farm or sell me his — and those prices varied widely over short periods of time depending on his mental state — how in the world could I be other than benefited by his erratic behavior? If his daily shout-out was ridiculously low, and I had some spare cash, I would buy his farm. If the number he yelled was absurdly high, I could either sell to him or just go on farming. Owners of stocks, however, too often let the capricious and often irrational behavior of their fellow owners cause them to behave irrationally as well. Because there is so much chatter about markets, the economy, interest rates, price behavior of stocks, etc., some investors believe it is important to listen to pundits — and, worse yet, important to consider acting upon their comments. Those people who can sit quietly for decades when they own a farm or apartment house too often become frenetic when they are exposed to a stream of stock quotations and accompanying commentators delivering an implied message of "Don't just sit there, do something." For these investors, liquidity is transformed from the unqualified benefit it should be to a curse. A "flash crash" or some other extreme market fluctuation can't hurt an investor any more than an erratic and mouthy neighbor can hurt my farm investment. Indeed, tumbling markets can be helpful to the true investor if he has cash available when prices get far out of line with values. A climate of fear is your friend when investing; a euphoric world is your enemy. During the extraordinary financial panic that occurred late in 2008, I never gave a thought to selling my farm or New York real estate, even though a severe recession was clearly brewing. And, if I had owned 100% of a solid business with good long-term prospects, it would have been foolish for me to even consider dumping it. So why would I have sold my stocks that were small participations in wonderful businesses? True, any one of them might eventually disappoint, but as a group they were certain to do well. Could anyone really believe the earth was going to swallow up the incredible productive assets and unlimited human ingenuity existing in America? ************ When Charlie and I buy stocks — which we think of as small portions of businesses — our analysis is very similar to that which we use in buying entire businesses. We first have to decide whether we can sensibly estimate an earnings range for five years out, or more. If the answer is yes, we will buy the stock (or business) if it sells at a reasonable price in relation to the bottom boundary of our estimate. If, however, we lack the ability to estimate future earnings — which is usually the case — we simply move on to other prospects. In the 54 years we have worked together, we have never foregone an attractive purchase because of the macro or political environment, or the views of other people. In fact, these subjects never come up when we make decisions. It's vital, however, that we recognize the perimeter of our "circle of competence" and stay well inside of it. Even then, we will make some mistakes, both with stocks and businesses. But they will not be the disasters that occur, for example, when a long-rising market induces purchases that are based on anticipated price behavior and a desire to be where the action is. Most investors, of course, have not made the study of business prospects a priority in their lives. If wise, they will conclude that they do not know enough about specific businesses to predict their future earning power. I have good news for these non-professionals: The typical investor doesn't need this skill. In aggregate, American business has done wonderfully over time and will continue to do so (though, most assuredly, in unpredictable fits and starts). In the 20th Century, the Dow Jones Industrials index advanced from 66 to 11,497, paying a rising stream of dividends to boot. The 21st Century will witness further gains, almost certain to be substantial. The goal of the non-professional should not be to pick winners — neither he nor his "helpers" can do that — but should rather be to own a cross-section of businesses that in aggregate are bound to do well. A low-cost S&P 500 index fund will achieve this goal. That's the "what" of investing for the non-professional. The "when" is also important. The main danger is that the timid or beginning investor will enter the market at a time of extreme exuberance and then become disillusioned when paper losses occur. (Remember the late Barton Biggs' observation: "A bull market is like sex. It feels best just before it ends.") The antidote to that kind of mistiming is for an investor to accumulate shares over a long period and never to sell when the news is bad and stocks are well off their highs. Following those rules, the "know-nothing" investor who both diversifies and keeps his costs minimal is virtually certain to get satisfactory results. Indeed, the unsophisticated investor who is realistic about his shortcomings is likely to obtain better long-term results than the knowledgeable professional who is blind to even a single weakness. If "investors" frenetically bought and sold farmland to each other, neither the yields nor prices of their crops would be increased. The only consequence of such behavior would be decreases in the overall earnings realized by the farm-owning population because of the substantial costs it would incur as it sought advice and switched properties. Nevertheless, both individuals and institutions will constantly be urged to be active by those who profit from giving advice or effecting transactions. The resulting frictional costs can be huge and, for investors in aggregate, devoid of benefit. So ignore the chatter, keep your costs minimal, and invest in stocks as you would in a farm. My money, I should add, is where my mouth is: What I advise here is essentially identical to certain instructions I've laid out in my will. One bequest provides that cash will be delivered to a trustee for my wife's benefit. (I have to use cash for individual bequests, because all of my Berkshire shares will be fully distributed to certain philanthropic organizations over the ten years following the closing of my estate.) My advice to the trustee could not be more simple: Put 10% of the cash in short-term government bonds and 90% in a very low-cost S&P 500 index fund. (I suggest Vanguard's.) I believe the trust's long-term results from this policy will be superior to those attained by most investors — whether pension funds, institutions or individuals — who employ high-fee managers. -- Warren Buffett, Berkshire Hathaway Letters to Shareholders, 2013, loc. 21357-21424