

BARRON'S Online

Monday, October 27, 2003

The Waiting Game

Unable to find bargains, Warren Buffett is making a pitch for patience

By **ANDREW BARY**

THE WORLD'S MOST SUCCESSFUL INVESTOR doesn't see a lot that appeals to him right now. A patient Warren Buffett, the chairman and chief executive of **Berkshire Hathaway**, is sitting on an enormous cash hoard -- more than \$24 billion -- awaiting investment opportunities in the stock and bond markets. In a wide-ranging interview last week at Berkshire's Omaha, Neb., headquarters, Buffett said that he's "not finding anything" in the stock market and isn't enamored of Treasury bonds or junk debt.

However, the 73-year-old CEO sounded upbeat on the outlook for his own company, whose stock has appreciated little this year despite stronger earnings and a rising book value. Berkshire's Class A shares finished Friday at \$76,000, up 4% this year and not much higher than they were in late 1998. The Class B shares, equal to 1/30th of a Class A share, stand at \$2,530. (For ways to buy Berkshire in little chunks, see [The Electronic Investor](#)¹.) Berkshire now trades for 22 times projected 2003 profits of \$3,500 per Class A share and for 1.7 times its book value of \$46,000 a share.

"I'm happy with the acquisitions that we've made in the past five years," Buffett said. Through a series of deals totaling more than \$15 billion, he's transformed Berkshire into a giant conglomerate with significant noninsurance businesses. These complement Berkshire's two other main operations: property and casualty insurance and investments, including a famed equity portfolio currently worth about \$32 billion.

Buffett said that Berkshire has paid, on average, about seven times pretax earnings for its acquisitions, an attractive price given current stock-market valuations. The Standard & Poor's 500 index trades for nearly 20 times projected 2003 operating profits and for 13 to 14 times pretax earnings. The company's notable acquisitions have included Shaw Industries, the leading U.S. carpet manufacturer; Benjamin Moore, the paint producer; Johns Manville, which makes insulation, roofing and other materials; and 80% of Mid-American Energy, an Iowa-based utility with large interests in the U.K.



Andy Freeberg

To Buffett, stocks are overvalued and junk bonds and Treasuries hold dangers. But he's high on one investment that's been a laggard: shares of his own

Buffett also is bullish on Berkshire's most important business: insurance, which includes Geico, one of the country's leading auto insurers. The unit also houses General Re, the big global reinsurer, and another reinsurance business geared toward catastrophes such as hurricanes and earthquakes that has achieved great results under Ajit Jain -- a manager whom many consider brilliant. Buffett called Berkshire's insurance operation "one of the best in the world." In recent years, Gen Re has been the weak link, suffering \$7 billion in underwriting losses from 1999 through 2002. But Gen Re had an underwriting profit in the first six months of 2003. "In my view, Gen Re is fixed," Buffett declared.

DOW JONES REPRINTS



This copy is for your personal non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers, use the Order Reprints tool at the bottom of any article or visit: www.djreprints.com. • [See a sample reprint in PDF format](#) • [Order a reprint of this article now.](#)

Berkshire Hathaway.

With his trademark insight and wit, Buffett also touched on the drug, technology, banking, supermarket, life-insurance and auto-insurance industries, as well as long-time Berkshire investments **Coca-Cola** and **Gillette**.

"We've got more cash than ideas," Buffett said. "The question is whether that will prevail for an unduly long time." Buffett added that he's "optimistic" that good opportunities will turn up, and noted that Berkshire had gone through fallow new-investment periods in the past.

Berkshire has made two sizable acquisitions this year, paying \$1.7 billion for Clayton Homes, a manufactured-housing maker and lender, and \$1.5 billion for McLane, a leading grocery wholesaler purchased from **Wal-Mart Stores**. Buffett is excited about both deals. He said that McLane, already a big supplier to **7-Eleven** and other convenience stores, now can do business with Wal-Mart competitors that once shunned it.

Berkshire paid about 12 times after-tax earnings for Clayton, a price deemed inadequate by many of the manufacturer's stockholders, who unsuccessfully tried to block the transaction. Berkshire paid roughly seven times pretax profits for McLane. In the past five years, Berkshire has shifted gears and focused on buying entire businesses, thus gaining full control over their earnings, rather than stakes in large public companies.

Buffett's market-related comments are consistent with those made in Berkshire's annual report, which was released in March, and at Berkshire's annual meeting in early May. In the annual, Buffett wrote that "despite three years of falling prices, which have significantly improved the attractiveness of common stocks, we still find very few that even mildly interest us."

In the interview, a gracious and energetic Buffett didn't provide any fresh information about who eventually will succeed him, an issue that probably is the top investor concern now about Berkshire. Buffett has said he plans to split his job in two, with one successor running Berkshire's investments and the other, the operating businesses. At Berkshire's annual meeting, he said there are four strong internal candidates, but he didn't name them. The long-time chief of investments at Geico, the 66-year-old Lou Simpson, probably will head Berkshire's investment side if Buffett dies or steps down in the next few years. But Buffett said he has no plans to retire.

Buffett, who doesn't give many interviews, made his comments in his downtown Omaha office and over lunch at the private restaurant in his office building (Buffett had a bacon, lettuce and tomato sandwich and an iced tea). His modest-sized corner office is dominated by a large photograph of his father, Howard, from the early 1940s, around the time the elder Buffett was elected to the U.S. House of Representatives from Nebraska. Unlike most chief executives, Buffett has no computer or financial-data terminal in his office. His e-mail is routed to his assistant, who prints it out for him.

There is a TV in a cabinet that Buffett will tune to CNBC when he's active in the stock market. Among the photos on the walls is one of his friend, the late Katharine Graham, former head of the Washington Post, and her son, Don Graham, the current Post CEO, who has benefited from Buffett's advice over the past 30 years. Berkshire owns a 17% stake in the Post, which under Don Graham has become one of the best-run U.S. media companies.

On Buffett's messy desk were reports from Berkshire subsidiaries, an earnings release from U.S. Bancorp and a video about Al Davis, owner of the Oakland Raiders football team.

Perhaps to add a dose of humility, Buffett has a set of the World Book encyclopedia on a table. The World Book business was part of an otherwise successful acquisition of the conglomerate Scott Fetzer in the early 1980s. The World Book, which once sold 300,000 encyclopedias annually at \$600 each, saw its business erode as encyclopedias migrated to cheaply priced CD-ROMS, in a move led by Buffett's friend, Microsoft's Bill Gates. Microsoft bought the Funk & Wagnall's business and then renamed it Encarta. Buffett says he still likes to peruse the old encyclopedias.

Table: [Berkshire's Allure²](#)

When this reporter arrived, Buffett was looking through e-mails sent to him by Michael Dell, the CEO

of Dell Computer, about the progress of Dell's wife, Susan, in the Ironman Triathlon in Hawaii. Susan Dell, 39, successfully completed that grueling event -- involving swimming, biking and running -- in 13½ hours, four hours behind the leading women, according to the Ironman Website. Buffett joked that, in contrast, he gets winded "walking up a flight of stairs." Buffett does have a computer at his Omaha home; he's an avid player of online bridge.

For a company with 60 subsidiaries and a market value of \$115 billion, Berkshire has unusually quiet offices. Buffett's phone didn't ring once during an hour in his office.

Berkshire's cash position grew to over \$24 billion on June 30 from \$10 billion at the end of 2002, largely reflecting first-half operating profits of \$2.7 billion and the sale of about \$9 billion of long-term Treasury bonds held in actively managed portfolios. Berkshire sold the bonds as long-term rates fell to their lowest levels in 40 years -- a smart move given the rate rise since midyear.

Buffett, who has spent a lifetime successfully playing the percentages, says that buying Treasury bonds at current levels probably isn't a smart move. He noted that Berkshire could be earning \$1 billion more annually on its investment portfolio if it shifted its cash holdings into longer-term Treasuries, but Buffett doesn't believe the risk is worth the added income. As he said in the Berkshire annual, earnings less than 1% after taxes on short-term investments is "no fun. But occasionally, successful investing requires inactivity."

Berkshire's reinsurance operations are all about playing the percentages and taking the kind of big risks from which most insurers shrink. Thanks to its fortress-like balance sheet and a triple-A credit rating, one of the last in the insurance industry, Berkshire can take billion-dollar risks involving hurricanes, earthquakes and offshore oil rigs, if the premiums are right. Berkshire is benefiting from the upturn in pricing seen in the past two years, as well as from its financial strength, which appeals to conservative primary insurers that want to lay off risk.

IN WARREN'S WORDS

The Berkshire boss' views on topics large and small:

On the stock market:

"We're not finding anything. ... We have more cash than ideas. The question is whether that will prevail for an unduly long time."

On junk bonds:

"We don't see anything attractive."

On Berkshire's many acquisitions:

"I'm happy with what we've done over the past five years." Deals were done for an average of "seven times pretax income."

On General Re, which suffered \$7 billion in operating losses from 1999 through '02:

"Gen Re, in my view, is fixed. ... We have one of the best insurance operations in the world."

On the drug industry versus technology:

Berkshire recently insured a PepsiCo sweepstakes that offered one lucky contestant a 1-in-1,000 chance of winning \$1 billion. The present value of that prize was about \$250 million. Buffett said other insurers wouldn't touch the contest because of the fear of losing \$250 million in a single event and wrecking their quarterly profits. But Berkshire took the risk because the premium was right. Buffett wouldn't divulge it, but says the premium was more than \$250,000, which is 1/1,000th of \$250 million. The bet paid off for Berkshire: The contestant lost. Turning toward this reporter, Buffett said he'd bet \$1 billion on the flip of a coin if the odds were 3 to 2 in his favor; the actual odds are even. As Buffett has often said: "At Berkshire, we would rather earn a lumpy 15% over time than a smooth 12%."

Berkshire's most notable investment last year was the purchase of about \$7 billion of junk debt as the high-yield market cratered in the summer and early fall after the bankruptcies of WorldCom and Adelphia Communications.

Given the sharp rally in junk this year, Buffett doesn't see much allure there. "We don't see anything attractive in junk bonds," Buffett said. He wishes Berkshire had bought more junk last year, but he would buy the depressed debt only of companies he understood.

Perhaps Berkshire's best deal in recent years was buying control of Mid-American Energy. Under Berkshire, the utility has purchased two big natural-gas pipelines at attractive prices in the past year. "Mid-American will be a big business in 10 years," Buffett said. "The growth will come in lumps." Berkshire paid about \$2 billion for its 80% stake in Mid-American and now is reaping profits at a rate of over \$300

"Drugs are a better business, in the aggregate, than technology. ... It's hard to find a drug company that has failed."

On Wal-Mart:

"It's a terrific operation that delivers good value. It's killing" the supermarkets.

On auto insurance:

"Our competition is Progressive. We and they have the best systems long term."

On "independent" board members at Fortune 500 companies:

"Aggregate board fees account for at least a third of the income of 20% of board members."

On his foundation's charitable mandate:

Find uses that "have a high benefit-cost ratio for society and no natural funding constituencies."

On Coca-Cola and Gillette:

"I made a mistake" in not selling them at their highs in the late 1990s. "They weren't the focal point of the bubble, but they achieved bubble prices."

million annually.

Looking ahead, Buffett says his two biggest challenges are "allocating capital intelligently and keeping the [Berkshire] managers happy." The first job is the toughest. After all, as he notes in the annual: "In 38 years, we've never had a single CEO of a subsidiary elect to leave Berkshire to work elsewhere."

Buffett has never been comfortable with technology stocks, and he's somewhat puzzled by the current valuation gap between major tech and drug issues. **Intel** and **Cisco Systems** command double the valuation of pharmaceutical leaders such as **Pfizer** and **Johnson & Johnson**. "Drugs are a better business in the aggregate than technology," Buffett argues, citing higher returns on capital and greater product longevity, owing to patent protection. "If you look at the top 10 drug companies ranked by sales, the No. 2 or No. 3 company from the bottom is still earning a good return. It's hard to find a drug company that has failed," Buffett says. In tech, by contrast, "the outstanding ones are outstanding," but there are fewer of them, he says. Tech companies, he adds, are more sensitive to the economy.

The master investor says that 40 years ago, Benjamin Graham identified something that's relevant to current tech valuations: "Companies with mystery are worth more than those without mystery."

Berkshire has long been involved in property and casualty insurance, but it has done little in life insurance, whose economics and inherent risks make Buffett wary. All too often, he says, "the sales force dictates the contract." Sellers of variable annuities, for instance, often guarantee minimum values on the death of the policyholder. With the S&P 500 index well below its peak, life insurers have had to

take financial charges to reflect the likely cost of those minimum death benefits. Variable annuities amount to mutual funds with a life- insurance wrapper.

Buffett also complains that life insurers often guarantee minimum interest rates on whole-life policies. If rates fall sharply, that can be very costly, as Japanese insurers have bitterly learned. Group life policies carry the risk that large corporate facilities could become terrorist targets. Buffett says that Berkshire was approached after Sept. 11 by a life company about reinsuring \$2 billion of group life policies above a \$1 billion threshold. The insurer balked at the high price that Berkshire felt would adequately reflect the true risk.

Buffett was criticized as irresponsible in the wake of Sept. 11 for discussing the risks of a terrorist attack involving biological, chemical or nuclear weapons. His response: The threat is real, if remote, and insurers owe it to their shareholders to consider such unthinkable events as a terrorist-inspired nuclear attack on Manhattan.

Buffett remains a big fan of Wal-Mart, noting that one of his biggest mistakes was not buying the stock years ago because it looked overvalued. "That cost us \$8 billion," he says. Owing to Wal-Mart, he's down on supermarket stocks, which are favored by many value-oriented investors: In Buffett's view, Wal-Mart, now the nation's largest grocer, "is killing" the supermarkets. "Wal-Mart is a terrific operation that delivers good value to people."

Looking at the banking industry, Berkshire says it's "amazing" that so many companies continue to earn returns on tangible equity of 20% or more, given that they all deal in a commodity -- money. Few insurers boast a 20% return on equity; **American International Group's** is around 15%. Banks have relatively low valuations at about 12 times next year's projected profits, a sharp discount

to the S&P 500, despite good earnings stability and persistently high returns.

Berkshire has done very well with its Coca-Cola and Gillette stakes, accumulated in the late 1980s. But Buffett says he erred by not selling them at their late 1990s peaks. Coke, at 45, and Gillette, at 30, are about 50% below their highs. "Coke and Gillette weren't the focal point of the bubble, but they achieved bubble prices," the Berkshire chief observes.

At their highs, Coke and Gillette traded for about 50 times earnings. Buffett said his role as a Coke and Gillette director would have made it nearly impossible for Berkshire to sell its stakes several years ago. As a director, Buffett might have been deemed to be in possession of insider information.

Those situations show the downside of being on corporate boards, Buffett adds. He's still a director at Coke, but not at Gillette. In the Berkshire annual, he and Vice Chairman Charlie Munger said they were "increasingly comfortable" with Coke, Gillette, **American Express** and other key equity holdings, but didn't view the stocks as being "undervalued." Coke and Gillette now trade at 20 to 25 times projected 2003 profits.

At a time when scandals involving Enron, Tyco International and WorldCom have thrown the spotlight on the role of corporate boards, companies are being forced to add more independent directors as a check against management. But Buffett wonders about their effectiveness. He estimates that for 20% of board members of Fortune 500 companies, "aggregate board fees account for a third of their income." Buffett questions how such directors can truly exercise independent judgment when they depend on the goodwill of management to remain on the boards.

Looking at the auto-insurance industry, Buffett had high praise for **Progressive** and **Mercury General**, both rivals of Berkshire's Geico.

Buffett views Progressive as Geico's chief competitor. "They and we have the strongest systems, long term," he comments. Progressive, like Geico, is growing rapidly by selling policies directly to drivers. Its stock has risen sharply in the past few years. Mercury General has become one of the largest California auto insurers through tight underwriting standards and the use of agents to weed out bad risks. Buffett calls Mercury's CEO, the 81-year-old George Joseph, "a hall of famer." Joseph and Hank Greenberg, the 78-year-old chief executive of insurance giant AIG, are renowned for the intimate knowledge of their organizations. "Not only do they know when every sparrow falls, they know what every sparrow is thinking," he says.

Buffett talked with *Barron's* on the day that Morgan Stanley's property and casualty insurance analyst, Vinay Saqi, began coverage of Berkshire with an Overweight rating and a price target of \$90,000 and downgraded AIG to Underweight from Equal Weight, citing the risk of the contraction in AIG's price/earnings multiple. He joked that Saqi should have done the opposite -- downgrading Berkshire and upgrading AIG -- because "Hank cares about that. I don't." Buffett says he doesn't focus on Berkshire's stock price and doesn't want a shareholder base that cares about market "squiggles." Buffett reiterated that he wants Berkshire investors to take a long-term view.

The Berkshire leader, who boasts that he's never sold a share of Berkshire, is pleased with its current base of shareholders, many of whom bought the stock in the mid-1960s, when he ended his investment partnership and took control of a textile maker called Berkshire Hathaway. Institutional ownership is low. Buffett's 31% stake is worth over \$35 billion.

Buffett says he's uninterested in splitting Berkshire stock or doing anything to promote it. He's proud that annual turnover in the A shares is less than 3% -- the lowest figure for any major U.S. company.

Buffett adds that Berkshire holders come in two classes, those who own the company on "faith" and those who analyze it extensively.

The "faith" investors tend to be those who've held it for a long time. A few years ago, the New York Times reported on a formerly unknown Brooklyn couple who left a \$750 million estate in Berkshire stock. Such fortunes are possible because an original investment of 1,000 shares of Berkshire in 1965, which would have cost \$20,000, is now worth \$75 million. Buffett says there are other investors like the couple, including four Berkshire billionaires not listed in the Forbes 400.

As for dividends, he says that most Berkshire shareholders "don't care" about them. And Buffett doesn't seem eager to offer any. (The company hasn't paid a cash dividend since 1967.)

Nevertheless, dividends are a possibility down the line because Buffett has said that if Berkshire can no longer create shareholder value by retaining profits, it will pay out its earnings to shareholders. Some investors would like to see an appreciable dividend, especially in light of the tax break individual recipients now get.

Berkshire may earn \$3,500 a share this year, or more than \$5 billion. Those earnings could easily support a dividend of \$1,500 a share, producing a 2% yield.

And in the post-Buffett era, Berkshire is apt to pay a dividend. That would remove some of the pressure on Buffett's successors to invest annual profits. It would also provide income to Buffett's foundation, which will receive about 99% of his Berkshire holdings following his death and that of his wife, Susan.

The foundation's goal, he says, will be to find uses that "have a high benefit-cost ratio to society and no natural funding constituencies." Buffett, who says he's in excellent health ("the top 1%" for his age, according to his doctor, he says), could be at Berkshire's helm for another five or 10 years or longer.

Late last week, Buffett flew to a California resort for a gathering of the "Graham Group" -- disciples and admirers of the late Benjamin Graham, one of the 20th century's great investors and an early Buffett mentor. The Berkshire chairman is the unofficial leader of this aging gang, which meets every two years. The 50 or so attendees, including spouses, were slated to include Charlie Munger, Walter Schloss, Bill Ruane and Lou Simpson.

Another attendee was Bill Gates, who injects some relatively young blood into the event. Gates turns 48 this week. One of the main topics at prior retreats for these wealthy men has been philanthropy.

As Buffett describes it, the group's focus has shifted over the years: "First, it was: 'How do we make money?' Then it was: 'How do we spend money?' Now, it's: 'How do we give it away?'" Buffett says that Gates, who has given away \$25 billion so far, including funding to eradicate malaria in parts of the developing world, has done a great job.

So has Buffett at Berkshire, in part because he knows when it's time to invest and when it's time to be patient.
