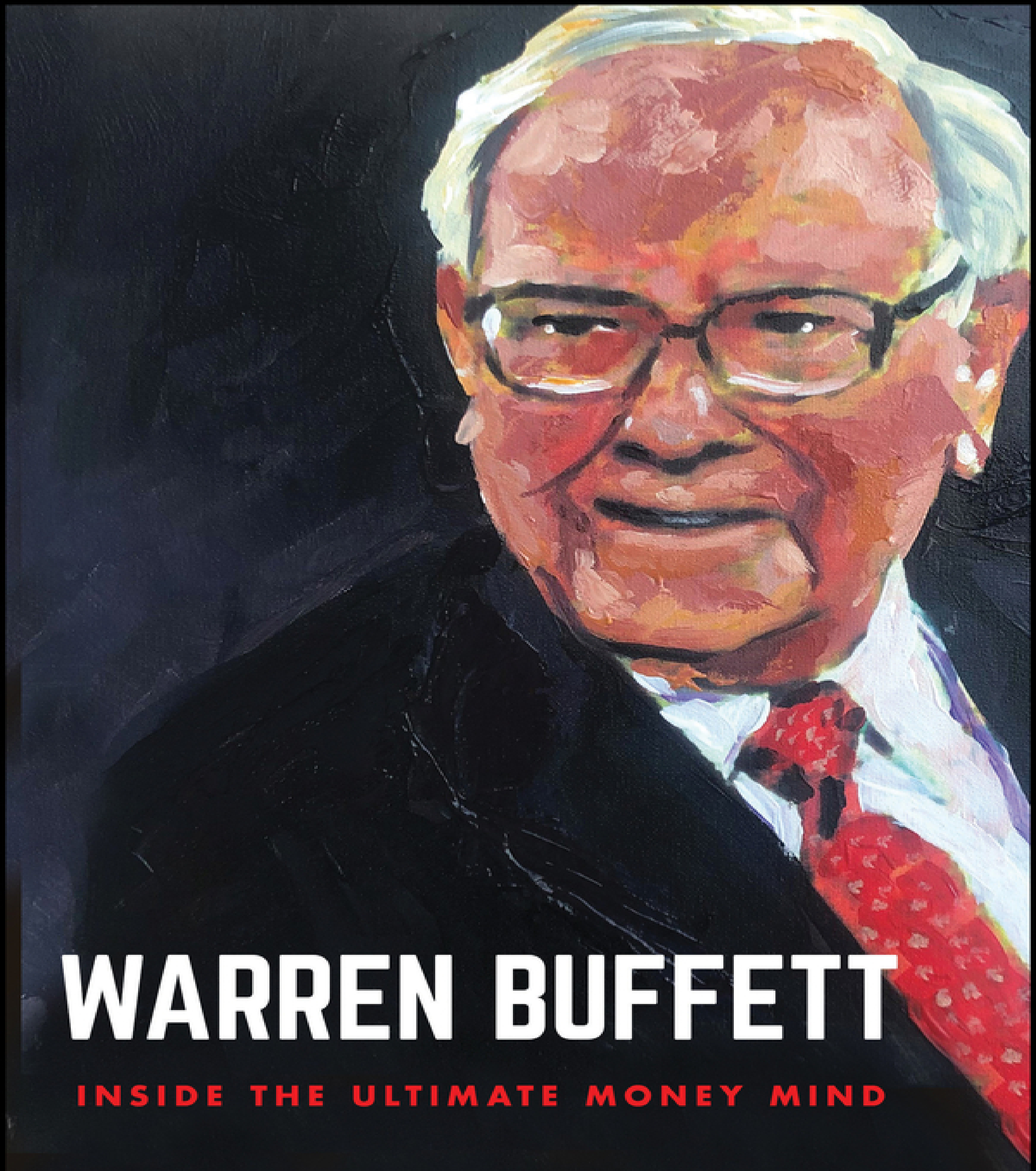

WARREN BUFFETT

INSIDE THE ULTIMATE MONEY MIND

ROBERT G. HAGSTROM

WILEY

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Prologue

Omaha, Nebraska. May 6, 2017.

It's the first Saturday in May, and for those who follow Warren Buffett, that means just one thing: the annual Berkshire Hathaway shareholder meeting. In the investment world, there is nothing quite like it.

For five straight hours (not counting a one-hour lunch break), Warren, and Charlie Munger, chairman and vice chairman of Berkshire Hathaway, answer questions from shareholders in the audience, from finance journalists on behalf of their readers and viewers, and from securities analysts. No attempt is made to vet the questions ahead of time, and every one is answered fully and with candor, warmth, and the gentle wit that is the trademark of both men. There is nothing on the head table but water glasses, cans of Coke, See's candy and peanut brittle, and two microphones; no notes, no briefing books, just two men happy to answer questions and talk about their ideas. Some 30,000 people hang on their every word. I am one of them.

Earlier that morning I had driven from my hotel to the Century Link Center in downtown Omaha, site of the event. The parking lot was nearly full. The 20,000-seat arena was already filled with Berkshire Hathaway shareholders, with thousands more filing into the overflow ballrooms that surround the arena. Many had been in line since 4:00 a.m., waiting for the doors to open at 7:00. Once inside, many of them dash directly for the line of chairs set up at the 11 microphone stations scattered around the arena and the surrounding ballrooms; with any luck, the people sitting in those chairs will get a chance to ask their question.

There was a time I would have been in that early line with them. But I had stopped getting up at dawn years ago, and I was certainly too old to race down the grand hall, up the escalator then hop down the steps into the arena to grab one of the coveted seats. My routine was now more relaxed.

Once inside, I took my time meandering around the giant exhibition hall, with its booths displaying all the businesses Berkshire owns. It's like an indoor shopping mall. You can stock up on snacks like See's Candies, Dairy Queen ice cream, and Coke. You can browse modular homes, boats and recreational vehicles. You can check out the new colors of Benjamin Moore paint and the latest style of Kirby vacuum cleaners. You can even sign up for GEICO insurance.

Near 8:30 a.m., I head up to the second floor and walk into Grand Ballroom B, where I customarily take my seat. Several thousand chairs in the ballroom are divided into two sections, each with a massive television screen that will soon be showing the traditional Berkshire Hathaway movie before live streaming Warren and Charlie answering questions in the arena next door. I settle into the last row on the right-hand side, stretch out comfortably, and smile.

So far, everything seems exactly normal. There is no hint that at today's meeting, something remarkable will happen.

The format for the question and answer period is well established. On one side of the main table, where Warren and Charlie sit, there is a station for the three journalists—Carol Loomis of *Fortune*, Becky Quick of CNBC, and Andrew Ross Sorkin of the *New York Times*. They will present questions from their readers and viewers. On the other side is a station for the equity analysts: Jonathan Brandt, research analyst at Ruane, Cunniff & Goldfarb; Jay Gelb of Barclay's; and Gregg Warren, senior analyst at

Morningstar. And at those 11 stations, dozens of eager shareholders sit nervously in their chairs, mentally rehearsing their questions.

Warren serves as master of ceremonies, calling first on one of the journalists, then one of the analysts, then one of the audience stations, in numerical order; then back to the journalists for the next cycle.

The morning session begins as usual. There's a question about driverless trucks and the threat it may pose to BNSF Railway or GEICO. Another question about Berkshire's reinsurance deal with American International Group. A discussion about technology stocks including IBM, Apple, Google, and Amazon. Warren was asked about the competitive nature of the airline industry, his thoughts on Coca-Cola, and the continuing struggle with Kraft Heinz.

Then, toward the end of the morning session, a shareholder at station 9 asked the 28th question, addressed to both Warren and Charlie. “The two of you have largely avoided the capital allocation mistakes by bouncing ideas off of one another. Will this continue long into Berkshire's future?” Although on the surface the question is about capital allocation, its focus is clearly on succession and who will be making capital allocation decisions in the future.

Warren responds first. “Any successor that's put in at Berkshire, capital allocation abilities and proven capital allocation abilities are certain to be the uppermost in the board's mind.” He points out that CEOs of a great many companies get to the top from a variety of backgrounds, including sales, legal, or manufacturing. But once in a leadership role, the CEO has to be able to make the decisions on allocating capital. “Berkshire would not do well if somebody was put in who had a lot of skills in other areas but really did not have an ability to allocate capital.”

What he said next made me sit upright in my chair.

Warren begins, “I've talked about it as being something I call a Money Mind. People can have 120 IQs or 140 IQs or whatever it may be, and some of them have minds that are good at one kind of thing and some of them another. They can do all kinds of other things that most mortals can't do. But I have also known very bright people who do not have Money Minds and they can make very unintelligent decisions. That skill [capital allocation] isn't the way their wiring works. So we do want somebody and hopefully they've got a lot of talent. But we certainly do not want somebody if they lack a Money Mind.”

A Money Mind. I had never heard Warren say those words before. At that moment I knew that after all those years of studying Warren Buffett, I was only half right.

■ ■ ■

My first exposure to Warren Buffett was in July 1984. I was training to be a stockbroker with a Mid-Atlantic brokerage firm. Part of my training included reading a Berkshire Hathaway annual report. Like so many, I was instantly impressed with the clarity of Warren's writing. Most importantly, I was struck with how sensibly he laid out the idea that owning a stock was equivalent to owning a business. As a liberal arts major in college, I didn't study finance or accounting, so trying to understand stocks using rows of numbers in balance sheets and income statements did not come easy to me. But when Warren explained that stocks should be thought of as companies run by managers who sell products to consumers, suddenly everything made sense.

When I earned my broker stripes and went into production I knew exactly what I was going to do. I was going to invest my clients' money in Berkshire Hathaway and in the stocks Berkshire bought for its own portfolio. I wrote to the

Securities and Exchange Commission for all the past Berkshire Hathaway annual reports and the annual reports of the public companies Berkshire owned. Over the years, I collected all the newspaper and magazine articles written about Warren and Berkshire. I was like a kid following a ballplayer.

I have never met anyone who disagrees with Warren's investment principles. These principles became the investment tenets in *The Warren Buffett Way*. And when I asked a client if they would like to invest in the same way, the answer was almost always yes, definitely! But as time passed, I discovered some investors who had chosen to invest like Warren were struggling. The gap between knowing why you own a stock and having the emotional wherewithal to withstand the push and pull of the market was, for many, too wide. I came to understand there was a big difference between knowing the path and walking the path.

But on that Saturday 30-some years later, I finally realized what was needed to help people invest successfully had less to do with the investment tenets and much more to do with the right mindset. Although both Ben Graham and Warren had for years written about the importance of temperament, I had pushed aside that idea in favor of sharpening my pencil to figure out what a stock was worth. The harder it became for people to invest in the stock market, the more I sharpened my pencil. Then, on that Saturday morning I finally realized I had discounted the most important advice.

■ ■ ■

What does it mean to have a Money Mind? Exploring that question, and all its ramifications, is the goal of this book. We will accomplish this by starting at the beginning, where we find some early influencers that may surprise you.

Example: Almost a decade before he first read *The Intelligent Investor*, 11-year-old Warren was intrigued by a book he found in the local public library. F. C. Minaker's *One Thousand Ways to Make $1000* helped form his earliest ideas of a Money Mind. Example: The role and influence of Warren's father in shaping the underpinnings for Warren's investment philosophy has not often been addressed in writings about Warren. Example: We know that young Warren studied everything about finance and investing he could get his hands on, but he also began to incorporate the principles of rationalism and pragmatism, two precepts crucial to a true Money Mind.

Then, once he had acquired the basic building blocks of a Money Mind, how did Warren employ that mindset to successfully navigate the investment landscape these past 65 years? We will explore the ways others might incorporate those building blocks into their own mental framework, so that they ultimately become a person we can now call a Money Mind. And most importantly, we will show how such a person can best manage their portfolio in this new, fast-paced, media-frenzied world. Finally, armed with this knowledge, we will make the argument that those investors who work toward achieving a Money Mind will stand a much better chance of becoming successful.

Let me be clear. This is an entirely new book. It is not a new edition of *The Warren Buffett Way*. It is not an update of the second edition that 10 years later combined the *Investment Strategies of the World's Greatest Investor* with the portfolio management approach outlined in *The Warren Buffett Portfolio: Mastering the Power of the Focus Investment Strategy*. Neither is it similar to the third edition, which added an eight-chapter investment workbook of questions, answers, and explanations meant to assess an understanding of the investment approach outlined by Warren Buffett. This is not a method book. It is a thinking book.

■ ■ ■

“Money Mind.” In his usual precise way, Warren gave us a memorable name for a complex notion. That easy-to-remember phrase describes, at one level, a way of thinking about major financial issues such as capital allocation. At another level, it summarizes an overall mindset for the modern business world. It identifies a person who has made a commitment to learning and stretching and facing down irrelevant noise. At a still deeper level, the profound philosophical and ethical constructs at its core tell us a great deal about the person we call a Money Mind, a person who is quite likely to be successful in many aspects of life—including investing. This Money Mind thing is a powerful idea. We should learn more about it.

CHAPTER 1
The Young Warren Buffett

Legends tend to accumulate around people who have accomplished something extraordinary in their lives. In particular, we seem to be fascinated with tidbits about their earliest years, wondering whether, if we look carefully, we could spot clues on how they became successful.

There are many popular stories that swirl around Warren Buffett, universally described as the world's greatest investor. You probably know most of them.

How at age six he set up a sidewalk table selling candy, gum, and soda pop. He bought a six-pack of Coca-Cola from his grandfather's grocery store for 25 cents and sold individual bottles for a nickel—a 20 percent return. The next year, he asked Santa Claus for a book about bonds. The year after that, he wanted more, so he began reading his father's books on the stock market. At age 11, he bought his first shares of stock. At age 17, he and a friend bought a used pinball machine for $25 and set it up in a neighborhood barber shop. With the proceeds, they bought two more machines. A year later, they sold the business for $1,200.

But there's one story you may not know, and it is quite possibly the most significant of all.

In 1941, 11-year-old Warren, browsing in the Benson branch of the Omaha Public Library, came across a distinguished-looking book with a shiny silver cover—*One Thousand Ways to Make $1000: Practical Suggestions, Based on Actual Experience, for Starting a Business of Your Own and Making Money in Your Spare Time* by F.C. Minaker, published by the Dartnell Corporation in 1936. In the fashion of the time, Frances Mary Cowan Minaker used initials to disguise her gender.

Think about a young boy living in Omaha, Nebraska, in the 1940s. There were no televisions, no video games, no personal computers, no smartphones. Yes, there were radio programs and a rare Saturday afternoon movie at the downtown cinema. But for most people, including Warren, entertainment was reading—newspapers, magazines, and books.

Now imagine young Warren running home from the library, tightly clutching his new treasure, bursting into the house, plopping down in a chair, opening the book to page 1 and diving into a new world of how to make money—a world he had not yet fully understood or appreciated.

Minaker's book is long (408 pages) and comprehensive. In addition to hundreds of specific suggestions for new businesses, it offers clear, straightforward lessons on good salesmanship, advertising, merchandising, customer relations, and much more. It is filled with stories of people who turned a good idea into a good business, sometimes with stunning success.

Some of the names are familiar today.

There is the stirring story of James C. Penney, whose first job paid him a measly $2.27 a month. Penney combined his small grubstake with two other partners and opened the first J.C. Penney on April 14, 1902. That first year, store sales amounted to $28,891. James' share of the profits was a tad over $1,000.

Warren flipped another page and read the story of 23-year-old John Wanamaker, who persuaded his brother-in-law, Nathan Brown, to combine their piddling savings and open a gentleman's clothing store in their home town, Philadelphia. Before them lay the prospects of a national civil war. Behind them were the remnants of the 1857 banking depression that caused massive unemployment and the almost complete ruination of manufacturers and wholesalers. Undeterred, they opened the doors on April 27, 1861; eight years later Wanamaker & Brown was the largest men's retailer in the United States.

With daydreams mounting, Warren read on.

When he came to page 153, Warren must have broken out with a huge grin. Chapter 6 is all about starting a roadside business—something the young entrepreneur had already been doing for more than five years. Chapter 10 is filled with scores of ideas for service businesses, one of which involved placing coin-operated pool tables in local stores and taverns. From our present-day perspective, we can see a straight line from that story to Warren's pinball business six years later.

In that same Chapter 10, “Selling Your Services,” we find another story, one that had an even greater influence on Warren's thinking. Here's what happened.

In 1933, a man named Harry Larson was shopping in his local drugstore when someone (we don't know who exactly) asked him how much he weighed. Harry turned around and spied a coin-operated scale; he put in his penny and got his answer and then moved over to the cigar counter. During the few minutes he waited in line, seven other customers decided to try the penny scale. That caught Harry's attention, and he set out to learn more. The store owner explained that the machines were leased and that his 25 percent share of the profits was about $20 a month (approximately $384 in today's dollars)—leaving 75 percent for the company that owned the scale.

That, Harry told Minaker, was the start of everything. He took $175 from savings, bought three machines, and was soon earning a monthly profit of $98. “Pretty good return on the investment,” he wryly noted. But it was what Harry did next that intrigued Warren. “I bought 70 machines altogether… . The other 67 were paid out of the pennies taken from the first three… . I've earned enough to pay for the scales, and made a good living besides.”[1]

That—one penny at a time—is the essence of compounding. We often think of compounding only as it applies to interest. You probably know Albert Einstein's famous quote: “Compound interest is the eighth wonder of the world, He who understands it, earns it; he who doesn't, pays it.” But at its the core the concept is broader and more powerful: use profits to make further profits. Harry Larson instinctively understood it; so did a young Warren Buffett.

Many years later, Warren used the penny-weight machines to describe his thinking. “The weighing machine was easy to understand,” he said. “I'd buy a weighing machine and use the profits to buy more weighing machines. Pretty soon I'd have twenty weighing machines, and everybody would weigh themselves fifty times a day. I thought—that's where the money is. The compounding of it—what could be better than that?”[2] It was that exact mental model that formed the outline, the architecture, of what would become Berkshire Hathaway.

And so we come back full circle to Minaker's book and its profound influence on Warren Buffett. *One Thousand Ways to Make $1000* lives up to the spirit, if not the letter, of its title: I count 476 new-business suggestions. Many would qualify as buggy-whip ideas in our high-tech world, but many others are remarkably prescient. But for us today, the real value of the book lies in the fundamental principles it offers. Minaker, in her no-nonsense, listen-to-your-teacher style, lays down important basic concepts about money. In particular, she wants readers to understand the mindset, the essential temperament they would need in order to reach their dollar goals. Taken together, those passages about the essence of making money are some of the key building blocks that helped form Warren's Money Mind.

“The first step in starting a business of your own,” Minaker writes, “is to know something about it… . So read everything published about the business you intend to start, to get the combined experience of others, and begin your plans where they left off.” That means, she insists, learning all you can from both sides of the question: how to succeed *and* how not to fail. Reading about a business, she says, is like sitting down with a businessman in his parlor and talking about your problems. “Only those who think they know all there is to be known—and more besides—consider such an exchange of ideas foolish,” she writes. What's really foolish, she points out, is spending hundreds of dollars (in today's dollars, probably hundreds of thousands, even millions) to discover that your idea won't work, when someone else who has already tried it and wrote about it can tell you “exactly *why* it is not a good idea.”[3]

To give her readers a boost with their research, Minaker includes a 35-page appendix that lists books, magazines, periodicals, pamphlets, and government publications related to how to start and operate a business. In all, there are 859 different citations on how to succeed at your chosen business.

The lesson was not lost on Warren. At Berkshire Hathaway's headquarters in Omaha, the largest room on the executive floor is not Warren's office but the reference library down the hall. It is lined with row upon row of filing cabinets, all filled with the stories of businesses. These cabinets contain every annual report, past and present, of all the major publicly traded companies. Warren has read them all. From these he has learned not only what worked and was profitable but, more important, what business strategies failed and lost money.

The second step in developing a Money Mind is simple enough to articulate but hard for most people to do. It can be encapsulated in two words: Take action. Or, as Minaker so compellingly puts it, “The way to begin making money, is to begin.”[4] Hundreds of thousands of people have dreamed about starting their own business, she notes, but never did because they were stuck. Waiting for business forecasts to improve, or perhaps waiting for their own prospects to get better, or just simply waiting for the right moment. They often delay getting started, Minaker writes, “because they cannot see clearly ahead.” The caution here is to be aware that the perfect moment is never known beforehand, and waiting for it is simply a way to hide in the safety of doing nothing.

Another manifestation of this phenomenon, Minaker points out, is people who become frozen because they spend too much time seeking counsel from others. “If you ask the advice of enough people,” she warns, “you are sure to almost end up doing nothing.”[5] On the surface that might seem to contradict the first dictum (learn everything you can) but it is really a question of common sense and balance. Finding the right balance between educating yourself and then knowing when to take action is, in fact, a key element of a Money Mind.

Those who have studied Warren Buffett easily recognize Minaker's counsel. Yes, Warren discusses big ideas with his long-time business partner, Charlie Munger. But it is also true that if Warren believes Berkshire is in line to make a good purchase he won't spend all day talking on the phone. He never pauses to make a final decision because the stock market is up or down, or the economy is growing or contracting, or the forecast for interest rates is rising or falling. If it is a good business at a good price, Warren takes action.

Along with her advice, Minaker also delivers compelling inspiration. “Leaving the harbor [with your new business] is like the captain of a ship at sea; you rely on your own judgment and ability,” she writes. She calls it the most satisfying part of a business life.[6]

It's easy to imagine the young Warren recognizing the truth of that. From the time he started selling candy and soda pop at age six, Warren was his own boss. He was steadfastly confident and loved his independence. By the time he graduated high school he was already the richest 16-year-old in Omaha. He may very well have been the world's richest self-made teenager. But he was not yet the millionaire he had once bragged about becoming. That required him to stay in school.

■ ■ ■

In 1947, Warren enrolled at the Wharton School of Finance and Commerce at the University of Pennsylvania. Despite his father urging him toward higher education, Warren was not easily motivated. He figured he was already doing well and that college would be a waste of time. Anyway, he had already read over a hundred books on business and investing. What could college teach him?

Warren was right. After two unrewarding years at Wharton it was clear he knew more than his professors about accounting and business. Warren was spending more time at Philadelphia brokerages studying the stock market than studying for class. When the fall semester began in 1949, Warren was nowhere to be found.

Back in Omaha, Warren enrolled at the University of Nebraska, and earned a bachelor's degree in one year taking 14 courses over two semesters. All that year, and even after graduating, most days Warren could be found in the library absorbing every book he could find on business and investing.[7]

Sometime in that summer of 1950 he found a copy of a newly published book by Benjamin Graham—*The Intelligent Investor*. More than any of the hundreds of books he had read, he regards this one as the book that changed his life.

It led him to start researching business schools, and later that same summer he discovered that Benjamin Graham and David Dodd, coauthors of the seminal work *Security Analysis*, were listed as professors at Columbia University. "I figured they were long since dead," he said.[8] So he quickly submitted an application to Columbia and was accepted. By September 1950 he was 1,200 miles away from Omaha, walking onto the New York City campus.

Warren's first class was Finance 111-112, Investment Management and Security Analysis, taught by David Dodd.[9] Before heading to New York, Warren had grabbed a copy of *Security Analysis*; by the time he got to Columbia, he had practically memorized it. "The truth was that I knew the book. At that time, literally, almost in those seven or eight hundred pages, I knew every example. I just sopped it up," he said.[10]

When the spring semester began in 1951, Warren could hardly contain himself. His next class was taught by Benjamin Graham, a seminar that combined the teachings in *Security Analysis* and the lessons from *The Intelligent Investor* linked to actual stocks that were then trading in the market.

Graham's message was simple to understand but revolutionary in practice. Before *Security Analysis*, the common Wall Street approach to picking stocks was to begin with some overall opinion about a stock—do you like it or not—then to try to figure what other people might do with that stock—buy or sell it. The financial facts were largely overlooked. Ben Graham backed up the train. Before you throw money at a stock based upon nothing more than prevailing opinions, he argued, why not first figure out what it might be worth.

In the beginning, Graham's method was simple: Add up the company's current assets (account receivables, cash and securities), then subtract all its liabilities. That gives you the company's net worth. Then, and only then, look at the stock price. If the price was below the net assets, it was a worthwhile and potentially profitable purchase. But if the stock price was higher than the company's net worth, it wasn't worth investing. This approach fit comfortably into Warren's sense of numbers. Ben Graham had given him what he had been seeking for years—a systematic approach for investing: buy a dollar's worth of securities for 50 cents.

It has been said that for Warren, attending Columbia University was very much like the experience of someone emerging from a cave where he had lived all his life, stepping outside, blinking at the sunlight, perceiving truth and reality for the first time.[11] Warren relished every moment of the experience. When not in class, he could be found in the Columbia library reading old newspapers about the stock market going back 20 years. He never stopped, seven days a week from early in the morning to late in the evening. Most wondered if he ever slept. At the end of the semester, Warren received an A+, the first time Graham had ever awarded that grade in his 22 years at Columbia University.

When school was over, Warren asked Graham about working at Graham-Newman, the investment partnership Graham managed while teaching at Columbia. Graham turned him down. Warren offered to work for free. Again, a polite no thank you. So Warren returned to Omaha, determined to see what he could do on his own.

He was just turning 21 years old.

It Begins

When Warren arrived in Omaha the summer of 1951, his mind and energy were singularly focused on investing. He was no longer interested in part-time jobs to make extra money. First Graham then Warren's father cautioned him that now was not the time to invest in the stock market. A correction was long overdue, both men warned. Warren heard only Minaker: “The way to begin making money is to begin.”

Warren was offered a job at the Omaha National Bank but he turned it down, preferring the familiarity of his father's firm, Buffett-Falk & Company. A friend of Howard Buffett's asked if the name would soon become Buffett & Son; Warren replied, “Maybe Buffett & Father.”[12]

Warren threw his heart and soul into Buffett-Falk & Company. He enrolled in the Dale Carnegie course for public speaking and was soon teaching “Investment Principles” at the University of Omaha; the lectures were based on Graham's book *The Intelligent Investor*. He wrote a column for *The Commercial and Financial Chronicle* under the headline “The Security I Like Best.” In it he touted one of Graham's favorite investments, a little-known insurance company called Government Employees Insurance Co. (GEICO). Throughout this period, Warren maintained his relationship with Ben Graham and sent him stock ideas from time to time.

Then one day, in 1954, Graham called his former student with a job offer. Warren was on the next plane back to New

York.

The two years Warren spent at Graham-Newman were exhilarating but also frustrating. One of six employees, Warren shared an office with the legendary investors Walter Schloss and Tom Knapp. They spent their days pouring over the Standard & Poor's *Stock Guide* and pitching ideas for the Graham-Newman mutual fund.

Graham and his partner Jerry Newman batted down most of their recommendations. When the Dow Jones Industrial Average hit 420 in 1955, the Graham Mutual Fund was sitting on $4 million in cash. No matter how compelling were Warren's stock picks, the door for investing at Graham-Newman was closed. The only place for Warren's ideas was his own portfolio. The following year, 1956, Graham had enough. He retired and moved to Beverly Hills, California, where he continued to write and teach, this time at UCLA, until his death at the age of 82.

So Warren returned to Omaha for the second time, far different from the young graduate five years earlier. He was now older, more experienced, certainly wiser about investing, and definitely a lot richer. And he knew one thing for sure. He would never work for someone else again. He was ready to be his own captain.

Chapter Ten of *One Thousand Ways to Make $1000* is titled “Selling Your Services.” The chapter begins by asking the reader to take a personal inventory. Figure out what you're good at, Minaker instructed, what you do better than anyone else. Then figure out who needs help with that and how best to reach them.

Through his teaching at the University of Omaha and his popular column on investing, Warren had already begun to build his reputation in Omaha; the time at Graham-Newman only added to his credibility. So no sooner did he arrive in Omaha than family and friends pounced, asking him to manage their money. His sister Doris and her husband, his loving Aunt Alice, his father-in-law, his ex-roommate Chuck Peterson, and local Omaha attorney Dan Monen—all wanted in. Collectively, in the spring of 1956 they gave Warren $105,000 to invest. Thus was born the investment partnership Buffett Associates, with Warren as general partner.

When everyone gathered for the kickoff meeting at a local Omaha dinner club, Warren set the tone. He handed each person the formal partnership agreement, assuring them there was nothing nefarious about the legalistic look of the agreement. Then with complete disclosure he set the ground rules for the partnership.[13]

First, the financial terms. Limited partners would receive annually the first 6 percent return of the investment partnership. Thereafter, they would receive 75 percent of the profits, with the balance going to Warren. Any annual deficiencies in performance goals would be rolled over to the next year. In other words, if the limited partners didn't get their 6 percent return in any one year, it would be extended into the next year. Warren would not receive his performance bonus until his partners were made whole.

Warren told his partners he could not promise results, but he did promise that the investments he made for the partnership would be based on the value principles he learned from Ben Graham. He went on to describe how they should think about yearly gains or losses. They should ignore the daily, weekly, and monthly gyrations of the stock market—which, in any event, were beyond his control. He suggested they not even put overly much emphasis on how well or poorly the investments performed in any one year. Better, he thought, to judge results over at least three years. Five years was even better.

Lastly, Warren told his partners he was not in the business of forecasting the stock market or economic cycles. That meant he would not discuss or disclose what the partnership was buying, selling, or holding.

At dinner that night, everyone signed up for the partnership. Over the years, as more partners were added, they were given the same ground rules. Lest anyone forgot, Warren included the ground rules with the performance results sent every year to each partner.

In addition to the annual 6 percent performance bogey, Warren also believed it was helpful for the partners to judge how well he was doing compared to a broader stock index, the Dow Jones Industrial Average. Over the first five years, the results were impressive. From 1957 to 1961, the partnership achieved a cumulative return of 251 percent compared to the Dow's 74 percent.

Hearing about Warren's success, more investors joined in. By 1961, the Buffett Partnership had $7.2 million in capital—more than Graham-Newman managed at its peak. By the end of the year, $1 million of the Buffett Partnership belonged to Warren. He had just turned 31.

Warren was applying Graham's investment playbook for the Buffett Partnership, with stunning success. He continued to soundly beat the Dow Jones Industrial Average. After 10 years, the Buffett Partnership's assets had grown to over $53 million. Warren's share was near $10 million. In 1968, the Buffett Partnership returned 59 percent compared to the Dow's 8 percent. It was the single best performance year of the partnership. Ever the realist, Warren wrote to his partners that the results “should be treated as a freak—like picking up thirteen spades in a bridge game.”[14]

Despite the partnership's heroic performance returns, difficulties were mounting. Scouring the market, Warren was having great difficulty finding value. Bereft of investment ideas and more than a little fatigued with the performance derby he had been running for the past 12 years, in 1969 Warren announced that he was closing down the partnership. In a letter to his partners, Warren confessed he was out of step with the current market environment. “On one point, however, I am clear,” he said. “I will not abandon a previous approach whose logic I understand, although I find it difficult to apply, even though it may mean forgoing large and apparently easy profits to embrace an approach which I don't fully understand, have not practiced carefully and which possibly could lead to substantial permanent capital loss.”[15]

In 1957, Warren had set a goal to beat the Dow Jones Industrial Average by 10 percentage points each year. Over its 13-year period, 1957–1969, the average annual compounded rate of return for the Buffett Partnership was 29.5 percent (23.8 percent net to partners); the Dow return was 7.4 percent. In the end, Warren beat the Dow not by 10 percentage points per year but by 22! From its initial asset base of $105,000, the partnership had grown to $104 million in assets under management. For this, Warren earned $25 million.

In shutting down the Buffett Partnership, Warren took extra care to ensure all the partners clearly understood the next steps. He outlined three different options. For those who wished to remain in the stock market, Warren recommended Bill Ruane, a former Columbia classmate. Twenty million dollars in Buffett Partnership assets were transferred to Ruane, Cunniff, & Stires and thus was born the famous Sequoia Mutual Fund.

A second option for partners was to invest in municipal bonds. To Warren's mind, the 10-year outlook for stocks was approximately the same as for the less risky, tax-free municipal bonds. The consummate educator, Warren sent each partner a 100-page manifesto on the mechanics of buying tax-free bonds.[16] As a third option, partners could also allocate their assets to one of the partnership's major holdings—the common shares of Berkshire Hathaway.

Warren was, as always, upfront and plainspoken. He told his partners he was going to move his personal investment in the Buffett Partnership to Berkshire Hathaway. As Doc Angel, one of the early Buffett Partnership loyalists, said, “That's all anybody had to hear if they had any brains.”[17]

From Investment Partnership to a Compounding Conglomerate

Early in the Buffett Partnership timeline, Warren bought shares in a New England textile manufacturer, a merged enterprise of Berkshire Cotton Manufacturing and Hathaway Manufacturing. It was a classic Ben Graham purchase. The stock was selling for $7.50 per share with working capital of $10.25 and a hard book value of $20.20.

Warren was well aware of the difficulties US textile manufacturers faced in competing against much cheaper foreign imports. Even so, he couldn't resist the attractiveness of “picking up a discarded cigar butt that had one puff remaining in it.”[18] The “cigar-butt” theory is the name given to Graham's emphasis on buying hard assets on the cheap even though those assets had little economic vitality. With the cash and securities on the balance sheet along with even a limited potential for business profits going forward, Warren figured there was not much downside to Berkshire Hathaway and a reasonable likelihood of making money.

By 1965, the Buffett Partnership owned 39 percent of the Berkshire Hathaway common shares outstanding. Warren was then locked in a proxy battle with the board of directors to take over the company, fire the inept management, and replace them with better capital allocators. When the dust settled, Warren won the fight but in doing so found he had allocated 25 percent of the Buffett Partnership's assets to an economically sinking ship with no exit strategy. “I became the dog who caught the car,” he said.[19]

The journey from managing one of the greatest investment partnerships in history to then parlaying his net worth into owning a dying manufacturing business had all the makings of a Greek tragedy. What was Warren thinking?

It's clear what he was *not* thinking. He had no grand plan to engineer a complete turnaround. And even though he had Ben Graham whispering in his ear, he never intended to sell the company to a greater fool. Who would have wanted to buy a 75-year-old, low-margin, capital-intensive, labor-dependent, nineteenth-century New England maker of fabric liners for men's suits? No, Warren was guided by a stronger principle, a principle that in fact lies at the heart of his investing philosophy—long-term compounding.

From an early age, Warren was taught the benefits of compound interest. More important, he experienced the benefits of a compounding machine firsthand when he took the earnings from his various jobs and plowed them back into his little business enterprise. If one paper route was a good job for making money, then having two paper routes meant more money. If owning one pinball machine added to his savings, then owning three was even better. Even as a kid, Warren was not geared to spend the money he had earned.

In many ways, Warren's childhood enterprises were like a conglomerate, allowing him to transfer money unimpaired from one business to another or, better yet, plowing more money back into the best business. And 20 years later, a conglomerate is what he had with Berkshire Hathaway, although few recognized it.

Most thought that Warren had rolled the dice on a beaten-down textile business, but what they missed is that in one bold step he now owned a corporate entity called Berkshire Hathaway that in turn owned a textile company. Warren figured all he had to do was to wring out whatever cash was left from Berkshire Hathaway manufacturing and reallocate it to a better business. Fortunately, the textile group of manufacturers under the Berkshire name did generate enough capital to allow Warren to buy other businesses, which, as we will see, is a much brighter story. It wasn't long before the metamorphosis of Berkshire Hathaway was complete, from a single-line textile manufacturer to a conglomerate that owned a portfolio of diversified business interests.

In the 2014 Berkshire Hathaway Annual Report, Warren gave shareholders a short tutorial on the advantages of owning a conglomerate. “If the conglomerate form is used judiciously, it is an ideal structure for maximizing long-term capital.” A conglomerate is perfectly positioned to allocate capital rationally and at a minimal cost, he explained. Furthermore, a conglomerate that owns different businesses is in an ideal position: “Without incurring taxes or much in the way of other costs [it can] move huge sums from businesses that have limited opportunities for incremental investment to other sectors with greater promise.”[20]

You have probably noticed that with his decisions about Berkshire Hathaway, Warren had pulled away from the