

WILEY INVESTMENT CLASSICS

ROBERT G. HAGSTROM

30TH
ANNIVERSARY
EDITION

THE
WARREN
BUFFETT
WAY

FOREWORDS BY
PETER LYNCH,
BILL MILLER, AND
HOWARD MARKS



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Additional Praise for *The Warren Buffett Way*

"The Warren Buffett Way outlines his career and presents examples of how his investment techniques and methods evolved and the important individuals in that process. It also details the key investment decisions that produced his unmatched record of performance. Finally the book contains the thinking and the philosophy of an investor that consistently made money using the tools available to every citizen no matter their level of wealth."

from the foreword by Peter Lynch

"The book's popularity is a testimony to the accuracy of its analysis and the value of its advice. The enduring value of Hagstrom's work is due to this clear focus - although the book talks about investment techniques, it is fundamentally about principles. And principles do not change."

from the foreword by Bill Miller

"Warren Buffett is focused, disciplined, and purposeful; he's hard working; highly numerate and logical; he's a voracious collector of information. The attributes listed are rare, but not unique. It's just that few people are able to demonstrate all of them in action. It's the combination of all of them that has enabled Warren to succeed so exceptionally by applying *The Warren Buffett Way*."

from the foreword by Howard Marks

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“Robert Hagstrom presents an in-depth examination of Warren Buffett's strategies, and the ‘how and why’ behind his selection of each of the major securities that have contributed to his remarkable record of success. His ‘homespun’ wisdom and philosophy are also part of this comprehensive, interesting, and readable book.”

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“Warren Buffett is surely the Greatest Investor of this century – not so much because he built a great fortune with a free market as because he shared his important thinking with us and openly demonstrated the sagacity and courage so vital to success. Berkshire Hathaway has been my largest, longest investment. Warren has been my best teacher.”

Charles D. Ellis, Managing Partner, Greenwich Associates

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Chris Davis, Davis Advisors

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Martin S. Fridson, Author, *Financial theory, reporting, and history*

“Thank you, Robert Hagstrom, for the finely honed thinking, the clear writing, and the simple strategies that

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THE WARREN BUFFETT WAY

30TH ANNIVERSARY EDITION

ROBERT G. HAGSTROM

WILEY

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Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

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Library of Congress Cataloging-in-Publication Data Is Available:

ISBN 9781394239849 (Cloth)

ISBN 9781394239863 (ePDF)

ISBN 9781394239856 (ePub)

Cover Design: Wiley

Cover Image: © Michael Prince/The Forbes Collection/Contributor/Corbis via
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Foreword to the First Edition

One weekday evening early in 1989, I was home when the telephone rang. Our middle daughter, Annie, then 11, was first to the phone. She told me that Warren Buffett was calling. I was convinced this had to be a prank. The caller started by saying, "This is Warren Buffett from Omaha [as if I might confuse him with some other Warren Buffett]. I just finished your book, I loved it, and I would like to quote one of your sentences in the Berkshire annual report. I have always wanted to do a book, but I never have gotten around to it." He spoke very rapidly with lots of enthusiasm and must have said 40 words in 15 or 20 seconds, including a couple of laughs and chuckles. I instantly agreed to his request and I think we talked for 5 or 10 minutes. I remember he closed by saying, "If you ever visit Omaha and don't come by and see me, your name will be mud in Nebraska."

Clearly not wanting my name to be mud in Nebraska, I took him up on his offer about six months later. Warren Buffett gave me a personal tour of every square foot of the office (which did not take long, as the whole operation could fit inside less than half of a tennis court), and I said hello to all 11 employees. There was not a computer or a stock quotation machine to be found.

After about an hour we went to a local restaurant where I followed his lead and had a terrific steak and my first Cherry Coke in 30 years. We talked about jobs we had as children, baseball, and bridge, and exchanged stories about companies in which we had held investments in the past. Warren discussed or answered questions about each stock and operation that Berkshire (he never called his company Berkshire Hathaway) owned.

Why has Warren Buffett been the best investor in history? What is he like as an individual, a shareholder, a manager, and an owner of entire companies? What is so unique about the Berkshire Hathaway annual report, why does he donate so much effort to it, and what can someone learn from it? To attempt to answer those questions, I talked with him directly, and reread the last five annual reports and his earliest reports as chairman (the 1971 and 1972 reports each had only two pages of text). In addition, I had discussions with nine individuals who have been actively involved with Warren Buffett in varied relationships and from different viewpoints during the past four to over 30 years: Jack Byrne, Robert Denham, Don Keough, Carol Loomis, Charlie Munger, Tom Murphy, Carl Reichardt, Frank Rooney, and Seth Schofield.

In terms of his personal qualities, the responses were quite consistent. Warren Buffett is, first of all, very content. He loves everything he does, dealing with people and reading mass quantities of annual and quarterly reports and numerous newspapers and periodicals. As an investor he has discipline, patience, flexibility, courage, confidence, and decisiveness. He is always searching for investments where risk is eliminated or minimized. In addition, he is very adept at probability and as an oddsmaker. I believe this ability comes from an inherent love of simple math computations, his devotion and active participation in the game of bridge, and his long experience in underwriting and accepting high levels of risk in insurance and in reinsurance. He is willing to take risks where the odds of total loss are low and upside rewards are substantial. He lists his failures and mistakes and does not apologize. He enjoys kidding himself and compliments his associates in objective terms.

Warren Buffett is a great student of business and a wonderful listener, and he is able to determine the key

elements of a company or a complex issue with high speed and precision. He can make a decision not to invest in something in as little as two minutes and conclude that it is time to make a major purchase in just a few days of research. He is always prepared, for as he has said in an annual report, "Noah did not start building the ark when it was raining."

As a manager he almost never calls a division head or the chief executive of a company but is delighted at any time of the day or night for them to call him to report something or to seek counsel. After investing in a stock or purchasing an entire operation, he becomes a cheerleader and sounding board: "At Berkshire we don't tell .400 hitters how to swing," using an analogy to baseball management.

Two examples of Warren Buffett's willingness to learn and adapt himself are public speaking and computer usage. In the 1950s Warren invested \$100 in a Dale Carnegie course "not to prevent my knees from knocking when public speaking but to do public speaking while my knees are knocking." At the Berkshire annual meeting in front of more than 2,000 people, Warren Buffett sits on a stage with Charlie Munger, and, without notes, lectures and responds to questions in a fashion that would please Will Rogers, Ben Graham, King Solomon, Phil Fisher, David Letterman, and Billy Crystal. To be able to play more bridge, early in 1994 Warren learned how to use a computer so he could join a network where you can play with other individuals from their locations all over the country. Perhaps in the near future he will begin to use some of the hundreds of data retrieval and information services on companies that are available on computers today for investment research.

Warren Buffett stresses that the critical investment factor is determining the intrinsic value of a business and paying a fair or bargain price. He doesn't care what the general

stock market has done recently or will do in the future. He purchased over \$1 billion of Coca-Cola in 1988 and 1989 after the stock had risen over fivefold the prior six years and over five-hundredfold the previous 60 years. He made four times his money in three years and plans to make a lot more the next 5, 10, and 20 years with Coke. In 1976 he purchased a very major position in GEICO when the stock had declined from \$61 to \$2 and the general perception was that the stock was definitely going to zero.

How can the average investor employ Warren Buffett's methods? Warren Buffett never invests in businesses he cannot understand or that are outside his "circle of competence." All investors can, over time, obtain and intensify their circle of competence in an industry where they are professionally involved or in some sector of business they enjoy researching. One does not have to be correct very many times in a lifetime, as Warren states that 12 investment decisions in his 40-year career have made all the difference.

Risk can be reduced greatly by concentrating on only a few holdings if it forces investors to be more careful and thorough in their research. Normally more than 75 percent of Berkshire's common stock holdings are represented by only five different securities. One of the principles demonstrated clearly several times in this book is to buy great businesses when they are having a temporary problem or when the stock market declines and creates bargain prices for outstanding franchises. Stop trying to predict the direction of the stock market, the economy, interest rates, or elections, and stop wasting money on individuals who do this for a living. Study the facts and the financial condition, value the company's future outlook, and purchase when everything is in your favor. Many people invest in a way similar to playing poker all night without ever looking at their cards.

Very few investors would have had the knowledge and courage to purchase GEICO at \$2 or Wells Fargo or General Dynamics when they were depressed, as there were numerous learned people saying those companies were in substantial trouble. However, Warren Buffett also purchased stock of Capital Cities/ABC, Gillette, Washington Post, Affiliated Publications, Freddie Mac, or Coca-Cola (which have produced over \$6 billion of profits for Berkshire Hathaway, or 60 percent of the \$10 billion of shareholders' equity); these were all well-run companies with strong histories of profitability, and they were dominant business franchises.

In addition to his own shareholders, Warren Buffett uses the Berkshire annual report to help the general public become better investors. On both sides of his family he is descended from newspaper editors, and his Aunt Alice was a public school teacher for more than 30 years. Warren Buffett enjoys both teaching and writing about business in general and investing in particular. He taught on a volunteer basis when he was 21 at the University of Nebraska in Omaha. In 1955, when he was working in New York City, he taught an adult education course on the stock market at Scarsdale High School. For 10 years in the late 1960s and 1970s he gave a free lecture course at Creighton University. In 1977 he served on a committee headed by Al Sommer Jr., to advise the Securities and Exchange Commission on corporate disclosure. After that involvement, the scale of the Berkshire annual report changed dramatically with the 1977 report written in late 1977 and early 1978. The format became more similar to the partnership reports he had produced from 1956 to 1969.

Since the early 1980s, the Berkshire annual reports have informed shareholders of the performance of the holdings of the company and new investments, have updated the

status of the insurance and the reinsurance industry, and (since 1982) have listed acquisition criteria about businesses Berkshire would like to purchase. The report is generously laced with examples, analogies, stories, and metaphors containing the dos and don'ts of proper investing in stocks.

Warren Buffett has established a high standard for the future performance of Berkshire by setting an objective of growing intrinsic value by 15 percent a year over the long term, something few people, and no one from 1956 to 1993 besides himself, have ever done. He has stated it will be a difficult standard to maintain due to the much larger size of the company, but there are always opportunities around and Berkshire keeps lots of cash ready to invest, and it grows every year. His confidence is somewhat underlined by the final nine words of the June 1993 annual report on [page 60](#): "Berkshire has not declared a cash dividend since 1967."

Warren Buffett has stated that he has always wanted to write a book on investing. Hopefully that will happen someday. However, until that event, his annual reports are filling that function in a fashion somewhat similar to the 19th-century authors who wrote in serial form: Edgar Allan Poe, William Makepeace Thackeray, and Charles Dickens. The Berkshire Hathaway annual reports from 1977 through 1993 are 17 chapters of that book. And also in the interim we now have *The Warren Buffett Way*, in which Robert Hagstrom outlines Buffett's career and presents examples of how his investment technique and methods evolved as well as the important individuals in that process. The book also details the key investment decisions that produced Buffett's unmatched record of performance. Finally, it contains the thinking and the philosophy of an investor who has consistently made money using the tools available to every citizen no matter one's level of wealth.

PETER S. LYNCH
OCTOBER 1994

Foreword to the Second Edition

When Robert Hagstrom first published *The Warren Buffett Way* in 1994, it quickly became a phenomenon. To date [2004], more than 1.2 million copies have been sold. The book's popularity is a testimony to the accuracy of its analysis and the value of its advice.

Any time the subject is Warren Buffett, it is easy to become overwhelmed by the sheer size of the numbers. Whereas most investors think in terms of hundreds or perhaps thousands, Buffett moves in a world of millions and billions. But that does not mean he has nothing to teach us. Quite the opposite. If we look at what he does and has done, and are able to discern the underlying thinking, we can model our decisions on his.

That is the profound contribution of Robert's book. He closely studied Warren Buffett's actions, words, and decisions for a number of years, and then he set about analyzing them for common threads. For this book, he distilled those common threads into 12 tenets, timeless principles that guide Buffett's investment philosophy through all circumstances and all markets. In just the same way, they can guide any investor.

The enduring value of Robert's work is due to this clear focus—although the book talks about investment techniques, it is fundamentally about investment principles. And principles do not change. I can almost hear Warren saying, with his wry smile, “That's why they call them principles.”

The past 10 years have given us a vivid demonstration of that basic truth. In those 10 years, the trends of the stock market changed several times over. We witnessed a high-

flying bubble that made many people rich, and then a steep crash into a protracted, painful bear market before the market finally hit bottom in the spring of 2003 and started to turn back up.

All along the way, Warren Buffett's investment approach never changed. He has continued to follow the same principles outlined in this book:

- Think of buying stocks as buying fractional interests in whole businesses.
- Construct a focused, low-turnover portfolio.
- Invest in only what you can understand and analyze.
- Demand a margin of safety between the purchase price and the company's long-term value.

Berkshire Hathaway investors, as usual, reap the benefits of that steady approach. Since the recovery began in 2003, Berkshire Hathaway stock is up about \$20,000 per share, more than 30 percent, far surpassing the returns of the overall market over the comparable period.

There is a chain of thinking for value investors that begins with Benjamin Graham, through Warren Buffett and his contemporaries, to the next generation of practitioners such as Robert Hagstrom. Buffett, Graham's best-known disciple, frequently advises investors to study Graham's book *The Intelligent Investor*. I often make the same recommendation myself. And I am convinced that Robert's work shares with that classic book one critical quality: The advice may not make you rich, but it is highly unlikely to make you poor. If understood and intelligently implemented, the techniques and principles presented here should make you a better investor.

BILL MILLER

CHAIRMAN AND CHIEF INVESTMENT OFFICER,
LMM, LLC
OCTOBER 2004

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