Leyland Lines

November/December 2011

MARKET UPDATE

Leyland Lines is our monthly newsletter providing investors with our insights on the overall market, individual companies and other relevant issues. All the information contained in this newsletter is for general reading only and should not be taken as a personal recommendation. Companies and ideas discussed in this newsletter are not necessarily buy or sell recommendations. We don't know when the opportunity to purchase or sell at favourable prices may occur, but when it does we act decisively. For that reason we encourage clients to allow us discretion using our Individually Managed Account service.

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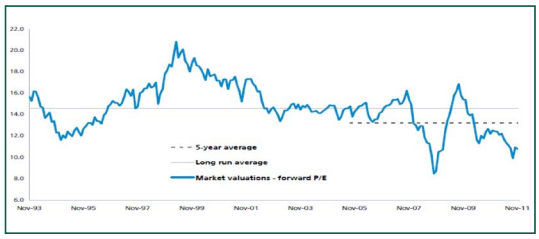
Welcome to the bumper November/December 2011 Christmas edition of Leyland Lines

Focus still remains on the economic and political situation in Europe, and volatility persists as markets oscillate between hope and despondency regarding the resolution of sovereign debt issues.

Whilst the macro environment is dictating investment trends, attention is being drawn away from recent robust company earnings numbers and positive economic indicators – especially in the US and Australia.

The Australian market is still trading at levels seen in 2003/2004, notwithstanding our positive economic performance since. More recently, the market rallied 15% (trough to peak) from its lows in early October. The recent decline has pushed the market to close to the October lows, with many companies paying a dividend since.

ASX 200 12 Month Forward P/E Ratio (cheap versus any historic comparison);



Market volatility serves to strengthen our conviction that the market is not always efficient but gyrates between oversold and overbought positions. We are of the view that the market is oversold, a position that is contradictory to most market commentators – only increasing our conviction.

The media serves to heighten fear, as fear sells. Positives are often under-reported and negatives are often amplified, as the headline "everything is OK" won't sell too many newspapers.

In this edition of Leyland Lines we revisit the Fairfax story. This company has been sold down recently by the Fairfax family, which we believe has created an overhang and an opportunity to purchase shares in an extremely undervalued business. This month we initiate coverage on Cash Converters, one of the few retailers that are doing quite well. We also look again at Resource Generation in light of the recent decline in share price from 99c to 38.5c. No edition of Leyland Lines would be complete without an article focusing on value investing. In this edition we include Warren Buffett's 1986 letter to shareholders.

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Welcome cont'd

We have recently aggregated our largest positions for our clients, and review the top five. In addition we review our comments from each month of the year; sometimes a historical perspective can be helpful, particularly in "uncertain" times. To quote Warren Buffett "Fear is the friend of the value investor".

During the month our managing director, Charles Leyland appeared on CNBC with Oriel Morrison, you can view the interview here:

http://video.cnbc.com/gallery/?video=3000058044

All the staff at Leyand Private Asset Management would like to wish you and your family a safe and happy Christmas. Let's hope 2012 provides the value investor with as many opportunities as 2011 has.

2011 in Review

Febuary
Many companies with reported good results have actually fallen…as they underperformed analysis forecasts.

March
Every month there will be new topics for the media to discuss, however, they rarely impact on long term share prices.

April
Resource may continue to run if commodity prices keep rising, but we prefer to focus on businesses with more predictable earnings.

August
Don't be scared of volatility; the most important aspects to whether a company is a worthwhile investment are the earnings, balance sheet and share price. Volatility only impacts price.

September
The market is forward looking and the near 30% discount to historical P/E averages indicates that significant negative news is priced in to Australian equities.

January
Last year was flat, and we constantly espoused the frailties of forecasting markets.

October
With earnings improving and the market staying low, the historic discount is becoming more pronounced.

May
Whilst we remain cautious about the broader direction of the Australian economy, we remain convinced that there are a number of companies which display attractive earnings outlooks.

June
Smart investors understand that excess returns over the long run will be achieved by investing in good quality businesses with sustainable earning capacity purchased at the lowest possible price.

July
One is unlikely to pick the absolute bottom, but buying good businesses cheaply is the soundest long term strategy.

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Market Update

We recently analysed our largest aggregate positions, and provide a summary of each below. Note that there are no banks and very little resource exposure. As true value investors, Leyland is able to purchase the best businesses for clients; we are not beholden to sector weightings. This is one key reason for our long term outperformance.

1. Telstra Corporation (11.77%)

P/E: 11x
ROE: 23%
EPS: $0.29
DPS: $0.28
Yield: 8.8% (100% franked)

Comment

Telstra's NBN deal underwrites the dividend in the near future (3 years). Market share of the mobile market is increasing as are margins. Customers returning to Telstra due to their superior wireless coverage, improved customer service and more competitive pricing.

2. Flexigroup (10.31%)

Price: $2.20
P/E: 10x
ROE: 23%
EPS : $0.21
DPS : $0.125
Yield: 6.6% (100% franked)

Comment

Leyland Private Asset Management has been a long term supporter of FlexiGroup. FlexiGroup is a quality provider of point-of-sale finance and telecommunication services. We believe that at 10x earnings and forecast EPS growth of 15%, the investment thesis is strong. However, FXL no longer trades at a discount to the market.

3. Fairfax (8.36%)

Price: $0.85
P/E: 7.8x
ROE: 8.1%
EPS: $0.11
DPS: $0.076
Yield: 9.0% (100% franked) - forecast

Comment

Fairfax is discussed in this edition of the newsletter. Please refer for analysis.

4. QBE Insurance (8.30%)

Price: $13.20
P/E: 10x
ROE: 12%
EPS: $1.57
DPS: $1.30
Yield: 9.86% (unfranked)

Comment

Last year was difficult with a number of catastrophes which impacted margins (11% versus 16% historically). Additionally, QBE invests much of their premium pool largely in US Bonds which remain at low emergency rates. QBE is trading at extremely low historic multiples; at a time when earnings are at cyclical lows. This provide an opportunity for investors to benefit from an earnings uplift and a p/e re-rating.

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Market Update cont'd

5. BHP Billiton (5.06%)

Price: 37.04
P/E: 9.2x
ROE: 45%
EPS: $4.06
DPS: $1.13
Yield: 3.0% (100% franked)

Comment

Whilst we are not as excited as the rest of the market about the "longer forever" story out of China, BHP provides a high quality diversified exposure to resources. They are an extremely low cost producer and will withstand a fall in commodity prices better than most.

Cash Converters (CCV)

cashconverters | convert your thinking

Previous Close	52 week high	52 week low
0.46	0.91	0.39
P/E Ratio		
6.06		
Sector		
Retailing		
Market Capital		
$173 million		

Cash Converters International operates as a retailer of second hand goods and a supplier of financial products such as short term loans (also known as Pay Day loans) and cash advances. Cash Converters was established in 1984. From its origins as a single store in Perth Western Australia, Cash Converters has grown into one of the world's largest 'Pawn Shop' dealers in the world with over 610 stores bearing the Cash Converters logo (mixture of company owned and franchise owned).

Country	Store Numbers
Australia	140
Belgium	20
Holland	8
Italy	1
France	78
Switzerland	3

Country	Store Numbers
Spain	65
Portugal	3
Canada	14
UK	197
Northern Ireland	2
USA	7
New Zealand	13
South Africa	46
Republic of Ireland	2
Thailand	1
Singapore	6
Malaysia	7
Total store numbers	613

Cash converters is one of the few Australian retailers that are doing quite well during this period of tough economic conditions. The main contributor to this resilience is quite simple; the earnings coming out of Cash Converters' 'Pay Day Loans' and short term cash advances are growing in double digits. For FY11, Cash Converters recorded a 27.5% increase in NPAT to $27.6m or an EBITDA of $43.5m. Out of this, 70% of earnings were attributed to their short term financial product offerings. This segement grew by 49% in FY11.

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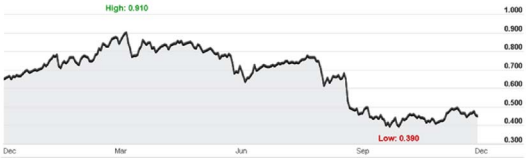
Cash Converters (CCV) cont'd

So why is CashConverters short term loan business booming?

Cash Converters main engine of profit growth could be considered to be counter-cyclical. History suggests that the worse the economy gets the more customers seek short term loans. It comes as no surprise that these short term loans are very expensive, sometimes priced at interest rates of up to 100% p.a. One must remember that Cash Converters and other 'Pay Day' loan operators charge these high rates as the loans are typically only a few hundred dollars and are usually oustanding for about 3 months, hence applying a per annum interest rate for comparison is not applicable.

Cash Converters (CCV) - 12 month graph



So why has Cash Converter's shares fallen significantly?

Simple. In August of this year Bill Shorten, Assistant Treasurer, announced plans to introduce legislation that caps lenders, such as Cash Converters, on what they can charge for short term loans. This single handedly caused the share price to crash from roughly 80c, to a low of 39c. Mr Shorten is proposing to cap the interest rate on short term credit contracts to 48% interest p.a. and an establishement fee not exceeding 10% of the credit contract.

Parliamentary comittee's findings on Mr Shorten's proposal

Hail common sense. The parliamentary committee reported its findings in the Senate on Friday 2nd December. They did not concur with Mr Shorten's view, hence did not recommend the 48%p.a. interest rate cap. The main reason for this is that they concluded that capping the interest rate at 48% and the establishment fee of 10% would render almost all short term loans under $2,000 unprofitable. It found that this would actually do more harm to consumers as there would simply not be an industry for short term loans. It is likely that Mr Shorten will change his approach by either disregarding his proposal to cap interest rates on short term loans entirely, or to radically change the rate from 48% to a level significantly higher.

Value Proposition

At the moment, at 46c Cash Converters is priced at 6 times FY11 earnings. Broker consensus estimates for FY12 suggest earnings will grow by 10% to 7.9 cents per share. This would put Cash Converters on a forward looking PE of 5.8. It seems that all the negative news is already priced into this stock. Any hint of some positive news could be enough of a catalyst for shares to rebound. We recommend to the value investor to keep this stock on their New Year's watchlist as over time, a business is priced on its long term cash-flows and not on short term sentiment.

Individually Managed Accounts (IMAs)

Leyland Private Asset Management has been running IMAs for over 6 years now. Most share portfolios are balanced with many self managed super funds also being run as an IMA.

The IMA vehicle is the ideal structure, as the client owns the shares. The timing of purchases and weightings in the most suitable sectors is much more efficient than managed funds. Capital gains management and franking credits are also major advantages of the IMA structure.

We believe that history will prove 2011 as a bellweather year for Australian equities. It is rare that one has the opportunity to purchase so many wonderful businesses at such attractive prices.

Over the long term good quality business models prevail; rarely does the market present such an opportunity to purchase these businesses at such attractive prices.

At Leyland we spend the majority of our time researching investment opportunities on behalf of our clients and believe that portfolio management cannot be undertaken piecemeal in an ad hoc manner.

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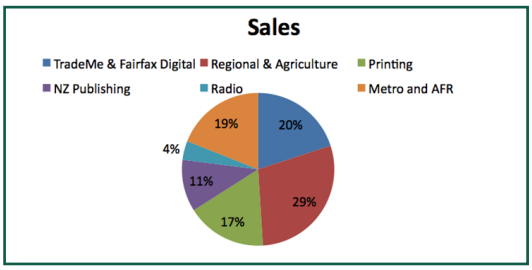
FAIRFAX (FXJ)

Price: $0.77
Market Cap: $1.82b

Fairfax (FXJ) is an Australian diversified media company. The group operates a portfolio of newspapers, magazines and internet businesses including news, classifieds, auction, dating and accommodation.

Management has been pro-active in positioning Fairfax with a diverse mix of earnings across markets and platforms.



Decline – Cyclical or Structural?

The market is giving a clear signal that it believes Fairfax is in 'structural' decline, as opposed to 'cyclical'. This may be true to some extent in the newspaper business, but other sectors have performed well.

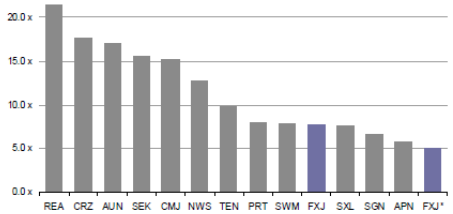
Although newspaper circulation is in decline, much of the down-side may already be factored in to the share price. Additionally, if newspapers are in structural decline it will take time to deteriorate to such a level that makes it uneconomical. In the meantime, this part of business is trading on 4x earnings.

	Revenue FY11 A$m	FY10 A$m	% change
Australian Regional Media	519.2	506.6	2.5%
Online - Fairfax Digital and Trade Me	234.2	212.4	10.3%
Australian and NZ Printing	83.2	83.0	0.2%
Metropolitan Media	873.3	895.6	(2.5%)
New Zealand Media	360.5	382.3	(5.7%)
Specialist Media	274.7	279.7	(1.8%)
Broadcasting	111.7	109.5	2.0%
Corporate and Other	12.1	15.5	(21.9%)
Total	2,468.9	2,484.6	(0.6%)

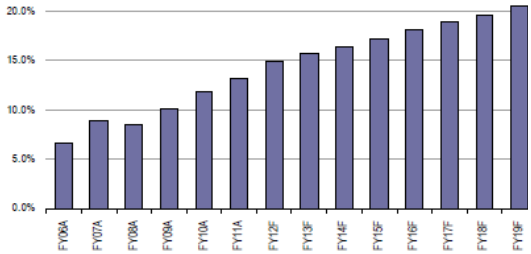
Value

At the current share price ($0.77), the company is trading on a price to earnings ratio of just 7 times. If we quarantine the non-newspaper assets, the 'old business' is trading closer to 5x earnings.

Post the IPO of TradeMe the remainder of Fairfax is valued at about 4x earnings.



FXJ Digital Revenues



TradeMe

Trade Me is a market leading online auction and classifieds site in New Zealand. As at 30 September 2011, TradeMe had more than 2.8 million members.

The partial sale of TradeMe will reduce debt and interest costs. Fairfax is floating 30% of TradeMe, with an expected total market cap of $NZ1.079bn ($AU$820m). The current total market capitalization of FXJ is AU$1.8bn. The IPO will highlight that value of that asset and facilitate deleveraging of the balance sheet.

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FAIRFAX (FXJ) cont'd

Stayz.com

Stayz has 80% of market share in the online holiday rental market. This is not hotel accommodation, but rather units and houses offered for short-term rent. Presently approximately 15% of total holiday rental in Australia is online with the vast majority being small privately owned and operated enterprises. We see clear growth in the aggregation of the holiday rental market, and Stayz is well positioned to benefit.

Others include;

SMH.com:	Sydney Morning Herald is the most viewed news site in Australia and second most visited site overall
Domain.com:	Online real estate advertiser
RSVP.com:	Market leading internet dating site
MyCareer.com:	Jobs website
Drive.com:	Car sales website
TheVine.com:	Entertainment portal

Similar listed digital businesses to those of Fairfax trade at very significant premiums;

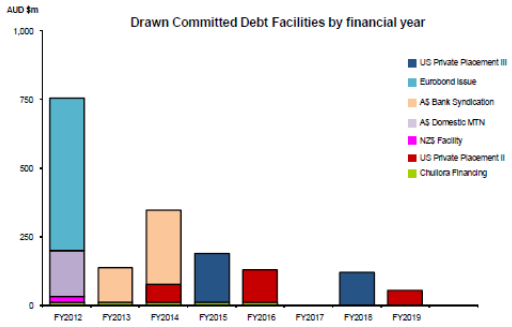
Carsales.com (CRZ):	18.0x earnings
SEEK (SEK):	18.8x earnings
Realestate.com:	22.0x earnings

That's not to say that Fairfax's online businesses can or will trade at those multiples, but it puts the value into perspective.

Balance Sheet

As at the end of FY11, net debt was $1.48bn. Chairman Roger Corbett explained that FXJ is "comfortably within all debt covenants and we are highly confident that debt maturities in 2012 and 2013 will be fully covered by cash flow from business operations together with unused credit facilities currently in place".

Fairfax debt repayment schedule



Following the IPO of TradeMe, net debt/EBITDA is expected to decline to 1.4x.

Debt to equity (2012e):	20%
Interest/EBIT Cover (2012e):	4.8x

Dividend

Management has indicated that the proceeds of the IPO of TradeMe will be used to pay down debt and increase the dividend. Currently FXJ pays out only 20% of earnings (3% yield). Assuming the pay-out is raised to 65%, the yield will increase to 8%, fully franked.

John Fairfax Divestment

It's also worth noting that John Fairfax, has diverted his 9.7% stake in the company at $0.835, and the pressure that selling has put on the stock has been measurable.

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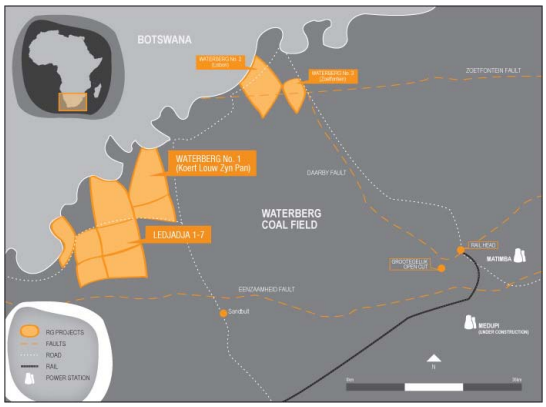
Resource Generation (RES)

Price: $0.405
Market Cap: $107.8m

Resource Generation is not the type of company Leyland normally invests in, or even considers. However, we have had previous dealings with the CEO, Paul Jury and have great respect for his ability to bring projects online.

The Boikarabelo coal mine in the Waterberg region contains the largest remaining coal deposits in South Africa. The Boikarabelo mine has probable reserves of 744.8 million tonnes of coal on 35% of the tenements under the company's control.



Map: Waterberg Coal Field South Africa

The company's tenements are held in two joint ventures being:

Ledjadja Coal- in which the Resource Generation has a 74% interest, with the remaining 26% held by its Black Economic Empowerment partner (BEE, which will be further discussed);

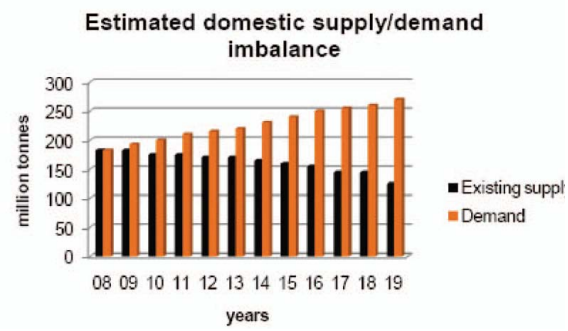
Waterberg One Coal- in which the company has a 70% interest with the balance held by a different BEE partner.

Demand for Coal

Whilst the headlines of the newspapers disparage the use of coal, the inexorable increase in demand for power over the next 20-50 years highlights the fact that coal is unlikely to become a redundant power source in the foreseeable future.

Not only is there significant demand growing from countries such as China and India, the demand for power from mature countries also remains strong.

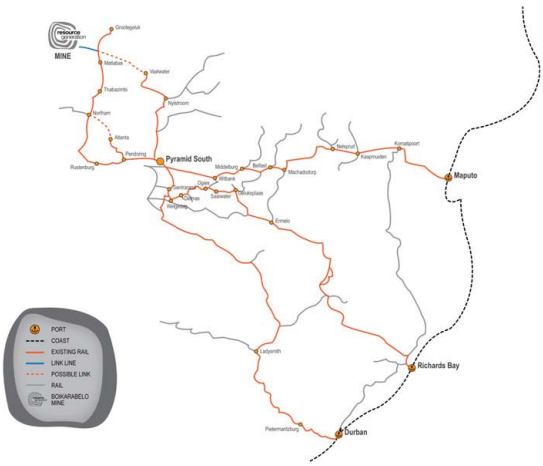
The graph below highlights the supply/demand imbalance in South Africa alone.



Event

A major concern the market has had regarding Resource Generation is that whilst they have an undoubted vast reserve of coal, the logistics of exactly how they would deliver their coal to ports was cloudy.

Recently the company signed a Memorandum of Understanding (MOU) with Transnet Freight Rail (TFR) for the rail transport of coal from the Boikarabelo project. Consensus view is that now this process is under way, a supply contract from a company called Eskom will be imminent to supply their power stations in Mpumalanga. It will also allow Resource Generation to export coal via Maputo, Richard's Bay and/or Durban (see rail accessibility map below).



Ma: Rail Accessibility

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Resource Generation (RES) cont'd

In Favour

The key reasons the company looks attractive are as follows:

- Large, shallow resource allowing for low cost opencast mining;
- The company has already been awarded a mining right for the Boikarabelo project and owns the surface rights over the planned mining area;
- Off-take agreements are in place to export coal with ICML (a 7% shareholder in RES) and Bhushan Steel for the majority of the coal from Stages 1 & 2 of the Boikarabelo project to be shipped to the respective companies' operations in India;
- The aforementioned MOU signed with TFR is a fundamental pillar in Resource Generation's investment case;
- By virtue of the joint ventures the company has signed, they have met all the requirements of the Black Economic Empowerment legislation whereby all mining assets must be 26% black-owned by 2014.

Risks

- Whilst the MOU signed with TFR is significant, it is not fully binding as yet. Also concerning is that the requisite coal railing capacity is not currently in place and thus TFR need to make a significant capital investment to resolve this. Whilst the intention is to put the railing capacity in place, it may take some time
- Falling coal price
- Key person risk
- Sovereign risk (racial dynamics in South Africa can change quickly).

The current market capitalisation of Resource Generation is only $107 million. The above mentioned mainly short-term risks are the reason this company is trading at an extraordinary discount considering the tonnes of coal in the ground and potential long term earnings from their massive mine. For investors willing to invest in a company which is higher risk, but offers the prospect of significant returns over the next five years, we believe this is a very exciting proposition on a risk/return basis.

NO TIME TO RUN YOUR SELF MANAGED SUPER FUND?

Leave the worry to us: Leyland Individually Managed Accounts

One of the biggest challenges for those people with Self-Managed Super Funds (SMSF) is finding the time to manage investments wisely to gain the best possible return on those investments.

Most investors want to maintain overall control, but recognise that their time and market knowledge sometimes limits their investment returns.

Please contact Leyland Private Asset Management if you would like to talk further about us managing you super fund equity investments.

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Warren Buffett's Letter to Shareholders March 1986

To the Shareholders of Berkshire Hathaway Inc.:

You may remember the wildly upbeat message of last year's report: nothing much was in the works but our experience had been that something big popped up occasionally. This carefully-crafted corporate strategy paid off in 1985. Later sections of this report discuss (a) our purchase of a major position in Capital Cities/ABC, (b) our acquisition of Scott & Fetzer, (c) our entry into a large, extended term participation in the insurance business of Fireman's Fund, and (d) our sale of our stock in General Foods.

Our gain in net worth during the year was $613.6 million, or 48.2%. It is fitting that the visit of Halley's Comet coincided with this percentage gain: neither will be seen again in my lifetime. Our gain in per-share book value over the last twenty-one years (that is, since present management took over) has been from $19.46 to $1643.71, or 23.2% compounded annually, another percentage that will not be repeated.

Two factors make anything approaching this rate of gain unachievable in the future. One factor probably transitory - is a stock market that offers very little opportunity compared to the markets that prevailed throughout much of the 1964-1984 period. Today we cannot find significantly-undervalued equities to purchase for our insurance company portfolios. The current situation is 180 degrees removed from that existing about a decade ago, when the only question was which bargain to choose.

This change in the market also has negative implications for our present portfolio. In our 1974 annual report I could say: "We consider several of our major holdings to have great potential for significantly increased values in future years." I can't say that now. It's true that our insurance companies currently hold major positions in companies with exceptional underlying economics and outstanding managements, just as they did in 1974. But current market prices generously appraise these attributes, whereas they were ignored in 1974. Today's valuations mean that our insurance companies have no chance for future portfolio gains on the scale of those achieved in the past.

The second negative factor, far more telling, is our size. Our equity capital is more than twenty times what it was only ten years ago. And an iron law of business is that growth eventually dampens exceptional economics; just look at the records of high-return companies once they have amassed even $1 billion of equity capital. None that I know of has managed subsequently, over a ten-year period, to keep on earning 20% or more on equity while reinvesting all or substantially all of its earnings. Instead, to sustain their high returns, such companies have needed to shed a lot of capital by way of either dividends or repurchases of stock. Their shareholders would have been far better off if all earnings could have been reinvested at the fat returns earned by these exceptional businesses. But the companies simply couldn't turn up enough high-return opportunities to make that possible.

Their problem is our problem. Last year I told you that we needed profits of $3.9 billion over the ten years then coming up to earn 15% annually. The comparable figure for the ten years now ahead is $5.7 billion, a 48% increase that corresponds - as it must mathematically - to the growth in our capital base during 1985. (Here's a little perspective: leaving aside oil companies, only about 15 U.S. businesses have managed to earn over $5.7 billion during the past ten years.)

Charlie Munger, my partner in managing Berkshire, and I are reasonably optimistic about Berkshire's ability to earn returns superior to those earned by corporate America generally, and you will benefit from the company's retention of all earnings as long as those returns are forthcoming. We have several things going for us: (1) we don't have to worry about quarterly or annual figures but, instead, can focus on whatever actions will maximize long-term value; (2) we can expand the business into any areas that make sense - our scope is not circumscribed by history, structure, or concept; and (3) we love our work. All of these help. Even so, we will also need a full measure of good fortune to average our hoped-for 15% - far more good fortune than was required for our past 23.2%.

We need to mention one further item in the investment equation that could affect recent purchasers of our stock. Historically, Berkshire shares have sold modestly below intrinsic business

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Instead, when owners wishing to understand the economic realities of their business asked for

data, managers usually gave them a we-can't-tell-you-what-is-going-on-because-it-would-hurt-the-company answer. Ultimately the SEC ordered disclosure of segment data and management began supplying real answers. The change in their behavior recalls an insight of Al Capone: "You can get much further with a kind word and a gun than you can with a kind word alone."

In the table, amortization of Goodwill is not charged against the specific businesses but, for reasons outlined in the Appendix to my letter in the 1983 annual report, is aggregated as a separate item. (A compendium of the 1977-1984 letters is available upon request.) In the Business Segment Data and Management's Discussion sections on pages 39-41 and 49-55, much additional information regarding our businesses is provided, including Goodwill and Goodwill Amortization figures for each of the segments. I urge you to read those sections as well as Charlie Munger's letter to Wesco shareholders, which starts on page 56.

	Pre-Tax Earnings		Berkshire's Share of Net Earnings (after taxes and minority interests)	
	1985	1984	1985	1984
Operating earnings Insurance Group:				
Underwriting	-$ 44,230	-$ 48,060	-$ 23,569	-$ 25,955
Net Investment Income	$ 95,217	$ 68,903	$ 79,716	$ 62,059
Blue Chip Stamps	$ 5,763	-$ 1,843	$ 2,813	-$ 899
Buffalo News	$ 29,921	$ 27,328	$ 14,580	$ 13,317
Mutual Savings and Loan	$ 2,622	$ 1,456	$ 4,016	$ 3,151
Nebraska Furniture Mart	$ 12,686	$ 14,511	$ 5,181	$ 5,917
Precision Steel	$ 3,896	$ 4,092	$ 1,477	$ 1,696
See's Candies	$ 28,989	$ 26,644	$ 14,558	$ 13,380
Textiles	-$ 2,395	$ 418	-$ 1,324	$ 226
Wesco Financial	$ 9,500	$ 9,777	$ 4,191	$ 4,828
Amortization of Goodwill	-$ 1,475	-$ 1,434	-$ 1,475	-$ 1,434
Interest on Debt	-$ 14,415	-$ 14,734	-$ 7,288	-$ 7,452
Shareholder Designated Contributions	-$ 4,006	-$ 3,179	-$ 2,164	$ 1,716
Other*	$ 3,106	$ 4,932	$ 2,102	$ 3,475
Operationing earnings	$ 125,449	$ 87,739	$ 92,948	$ 70,014
Special General Foods Distribution	$ 4,127	$ 8,111	$ 3,779	$ 7,294
Special Washington Post Distribution	$ 14,877	--	$ 13,851	--
Sales of securities	$ 468,903	$ 104,699	$ 325,237	$ 71,587
Total Earnings - all entities	$ 613,356	$ 200,549	$ 435,815	$ 148,895

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Our 1985 results include unusually large earnings from the sale of securities. This fact, in itself, does not mean that we had a particularly good year (though, of course, we did). Security profits in a given year bear similarities to a college graduation ceremony in which the knowledge gained over four years is recognized on a day when nothing further is learned. We may hold a stock for a decade or more, and during that period it may grow quite consistently in both business and market value. In the year in which we finally sell it there may be no increase in value, or there may even be a decrease. But all growth in value since purchase will be reflected in the accounting earnings of the year of sale. (If the stock owned is in our insurance subsidiaries, however, any gain or loss in market value will be reflected in net worth annually.) Thus, reported capital gains or losses in any given year are meaningless as a measure of how well we have done in the current year.

A large portion of the realized gain in 1985 ($338 million pre-tax out of a total of $488 million) came about through the sale of our General Foods shares. We held most of these shares since 1980, when we had purchased them at a price far below what we felt was their per/share business value. Year by year, the managerial efforts of Jim Ferguson and Phil Smith substantially increased General Foods' business value and, last fall, Philip Morris made an offer for the company that reflected the increase. 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.

> *"Any time anybody offers you anything with a big commission and a 200-page prospectus, don't buy it."*
>
> *Charlie Munger*

We have again reported substantial income from special distributions, this year from Washington Post and General Foods. (The General Foods transactions obviously took place well before the Philip Morris offer.) Distributions of this kind occur when we sell a portion of our shares in a company back to it simultaneously with its purchase of shares from other shareholders. The number of shares we sell is contractually set so as to leave our percentage ownership in the company precisely the same after the sale as before. Such a transaction is quite properly regarded by the IRS as substantially equivalent to a dividend since we, as a shareholder, receive cash while maintaining an unchanged ownership interest. This tax treatment benefits us because corporate taxpayers, unlike individual taxpayers, incur much lower taxes on dividend income than on income from long-term capital gains. (This difference will be widened further if the House-passed tax bill becomes law: under its provisions, capital gains realized by corporations will be taxed at the same rate as ordinary income.) However, accounting rules are unclear as to proper treatment for shareholder reporting. To conform with last year's treatment, we have shown these transactions as capital gains.

Though we have not sought out such transactions, we have agreed to them on several occasions when managements initiated the idea. In each case we have felt that non-selling shareholders (all of whom had an opportunity to sell at the same price we received) benefited

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because the companies made their repurchases at prices below intrinsic business value. The tax advantages we receive and our wish to cooperate with managements that are increasing values for all shareholders have sometimes led us to sell - but only to the extent that our proportional share of the business was undiminished.

At this point we usually turn to a discussion of some of our major business units. Before doing so, however, we should first look at a failure at one of our smaller businesses. 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.

Shutdown of Textile Business

In July we decided to close our textile operation, and by yearend this unpleasant job was largely completed. The history of this business is instructive.

When Buffett Partnership, Ltd., an investment partnership of which I was general partner, bought control of Berkshire Hathaway 21 years ago, it had an accounting net worth of $22 million, all devoted to the textile business. The company's intrinsic business value, however, was considerably less because the textile assets were unable to earn returns commensurate with their accounting value. Indeed, during the previous nine years (the period in which Berkshire and Hathaway operated as a merged

company) aggregate sales of $530 million had produced an aggregate loss of $10 million. Profits had been reported from time to time but the net effect was always one step forward, two steps back.

At the time we made our purchase, southern textile plants - largely non-union - were believed to have an important competitive advantage. Most northern textile operations had closed and many people thought we would liquidate our business as well.

We felt, however, that the business would be run much better by a long-time employee whom. we immediately selected to be president, Ken Chace. In this respect we were 100% correct: Ken and his recent successor, Garry Morrison, have been excellent managers, every bit the equal of managers at our more profitable businesses.

In early 1967 cash generated by the textile operation was used to fund our entry into insurance via the purchase of National Indemnity Company. Some of the money came from earnings and some from reduced investment in textile inventories, receivables, and fixed assets. This pullback proved wise: although much improved by Ken's management, the textile business never became a good earner, not even in cyclical upturns.

Further diversification for Berkshire followed, and gradually the textile operation's depressing effect on our overall return diminished as the business became a progressively smaller portion of the corporation. We remained in the business for reasons that I stated in the 1978 annual report (and summarized at other times also): "(1) our textile businesses are very important employers in their communities, (2) management has been straightforward in reporting on problems and energetic in attacking them, (3) labor has been cooperative and understanding in facing our common problems, and (4) the business should average modest cash returns relative to investment." I further said, "As long as these conditions prevail - and we expect that they will - we intend to continue to support our textile business despite more attractive alternative uses for capital."

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It turned out that I was very wrong about (4). Though 1979 was moderately profitable, the business thereafter consumed major amounts of cash. By mid-1985 it became clear, even to me, that this condition was almost sure to continue. Could we have found a buyer who would continue operations, I would have certainly preferred to sell the business rather than liquidate it, even if that meant somewhat lower proceeds for us. But the economics that were finally obvious to me were also obvious to others, and interest was nil.

I won't close down businesses of sub-normal profitability merely to add a fraction of a point to our corporate rate of return. However, I also feel it inappropriate for even an exceptionally profitable company to fund an operation once it appears to have unending losses in prospect. Adam Smith would disagree with my first proposition, and Karl Marx would disagree with my second; the middle ground is the only position that leaves me comfortable.

I should reemphasize that Ken and Garry have been resourceful, energetic and imaginative in attempting to make our textile operation a success. Trying to achieve sustainable profitability, they reworked product lines, machinery configurations and distribution arrangements. We also made a major acquisition, Waumbec Mills, with the expectation of important synergy (a term widely used in business to explain an acquisition that otherwise makes no sense). But in the end nothing worked and I should be faulted for not quitting sooner. A recent Business Week article stated that 250 textile mills have closed since 1980. Their owners were not privy to any information that was unknown to me; they simply processed it more objectively. I ignored Comte's advice - "the intellect should be the servant of the heart, but not its slave" - and believed what I preferred to believe.

> *"We need the intelligent commitment of capital, not leveraged market wagers."*
>
> *Warren Buffett*

The domestic textile industry operates in a commodity business, competing in a world market in which substantial excess capacity exists. Much of the trouble we experienced was attributable, both directly and indirectly, to competition from foreign countries whose workers are paid a small fraction of the U.S. minimum wage. But that in no way means that our labor force deserves any blame for our closing. In fact, in comparison with employees of American industry generally, our workers were poorly paid, as has been the case throughout the textile business. In contract negotiations, union leaders and members were sensitive to our disadvantageous cost position and did not push for unrealistic wage increases or unproductive work practices. To the contrary, they tried just as hard as we did to keep us competitive. Even during our liquidation period they performed superbly. (Ironically, we would have been better off financially if our union had behaved unreasonably some years ago; we then would have recognized the impossible future that we faced, promptly closed down, and avoided significant future losses.)

Over the years, we had the option of making large capital expenditures in the textile operation that would have allowed us to somewhat reduce variable costs. Each proposal to do so looked like an immediate winner. Measured by standard return-on-investment tests, in fact, these proposals usually promised greater economic benefits than would have resulted from

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comparable expenditures in our highly-profitable candy and newspaper businesses.

But the promised benefits from these textile investments were illusory. Many of our competitors, both domestic and foreign, were stepping up to the same kind of expenditures and, once enough companies did so, their reduced costs became the baseline for reduced prices industrywide. Viewed individually, each company's capital investment decision appeared cost-effective and rational; viewed collectively, the decisions neutralized each other and were irrational (just as happens when each person watching a parade decides he can see a little better if he stands on tiptoes). After each round of investment, all the players had more money in the game and returns remained anemic.

Thus, we faced a miserable choice: huge capital investment would have helped to keep our textile business alive, but would have left us with terrible returns on ever-growing amounts of capital. After the investment, moreover, the foreign competition would still have retained a major, continuing advantage in labor costs. A refusal to invest, however, would make us increasingly non-competitive, even measured against domestic textile manufacturers.I always thought myself in the position described by Woody Allen in one of his movies: "More than any other time in history, mankind faces a crossroads. One path leads to despair and utter hopelessness, the other to total extinction. Let us pray we have the wisdom to choose correctly."

For an understanding of how the to-invest-or-not-to-invest dilemma plays out in a commodity business, it is instructive to look at Burlington Industries, by far the largest U.S. textile company both 21 years ago and now. In 1964 Burlington had sales of $1.2 billion against our $50 million. It had strengths in both distribution and production that we could never hope to match and also, of course, had an earnings record far superior to ours. Its stock sold at 60 at the end of 1964; ours was 13.

Burlington made a decision to stick to the textile business, and in 1985 had sales of about $2.8 billion. During the 1964-85 period, the company made capital expenditures of about $3 billion, far more than any other U.S. textile company and more than $200-per-share on that $60 stock. A very large part of the expenditures, I am sure, was devoted to cost improvement and expansion. Given Burlington's basic commitment to stay in textiles, I would also surmise that the company's capital decisions were quite rational.

Nevertheless, Burlington has lost sales volume in real dollars and has far lower returns on sales and equity now than 20 years ago. 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. The situation is suggestive of Samuel Johnson's horse: "A horse that can count to ten is a remarkable horse - not a remarkable mathematician." Likewise, a textile company that allocates capital brilliantly within its industry is a remarkable textile company - but not a remarkable business.

My conclusion from my own experiences and from much observation of other businesses is that a 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). Some years ago I wrote: "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." Nothing has since changed my point of view on that matter.

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Should you find yourself in a chronically-leaking boat, energy devoted to changing vessels is likely to be more productive than energy devoted to patching leaks.

* * *

There is an investment postscript in our textile saga. Some investors weight book value heavily in their stock-buying decisions (as I, in my early years, did myself). And some economists and academicians believe replacement values are of considerable importance in calculating an appropriate price level for the stock market as a whole. Those of both persuasions would have received an education at the auction we held in early 1986 to dispose of our textile machinery.

The equipment sold (including some disposed of in the few months prior to the auction) took up about 750,000 square feet of factory space in New Bedford and was eminently usable. It 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.

Gross proceeds from our sale of this equipment came to $163,122. Allowing for necessary pre- and post-sale costs, our net was less than zero. Relatively modern looms that we bought for $5,000 apiece in 1981 found no takers at $50. We finally sold them for scrap at $26 each, a sum less than removal costs.

Ponder this: 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.

Three Very Good Businesses (and a Few Thoughts About Incentive Compensation)

When I was 12, I lived with my grandfather for about four months. A grocer y trade, he was also working on a book and each night he dictated a few pages to me. The title - brace yourself - was "How to Run a Grocery Store and a Few Things I Have Learned About Fishing". My grandfather was sure that interest in these two subjects was universal and that the world awaited his views. You may conclude from this section's title and contents that I was overexposed to Grandpa's literary style (and personality).

I am merging the discussion of Nebraska Furniture Mart, See's Candy Shops, and Buffalo Evening News here because the economic strengths, weaknesses, and prospects of these businesses have changed little since I reported to you a year ago. The shortness of this discussion, however, is in no way meant to minimize the importance of these businesses to us: in 1985 they earned an aggregate of $72 million pre-tax. Fifteen years ago, before we had acquired any of them, their aggregate earnings were about $8 million pre-tax.

While an increase in earnings from $8 million to $72 million sounds terrific - and usually is - you should not automatically assume that to be the case. You must first make sure that earnings were not severely depressed in the base year. If they were instead substantial in relation to capital employed, an even more important point must be examined: how much additional capital was required to produce the additional earnings?

In both respects, our group of three scores well. First, earnings 15 years ago were excellent compared to capital then employed in the businesses. Second, although annual earnings are now $64 million greater, the businesses require only about $40 million more in invested capital to operate than was the case then.

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The dramatic growth in earning power of these three businesses, accompanied by their need for only minor amounts of capital, 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. Corporate America, however, has had a different experience: in order to increase earnings significantly, most companies have needed to increase capital significantly also. The average American business has required about $5 of additional capital to generate an additional $1 of annual pre-tax earnings. That business, therefore, would have required over $300 million in additional capital from its owners in order to achieve an earnings performance equal to our group of three.

When returns on capital are ordinary, an earn-more-by-putting-up-more record is no great managerial achievement. You can get the same result personally while operating from your rocking chair. just quadruple the capital you commit to a savings account and you will quadruple your earnings. You would hardly expect hosannas for that particular accomplishment. Yet, retirement announcements regularly sing the praises of CEOs who have, say, quadrupled earnings of their widget company during their reign - with no one examining whether this gain was attributable simply to many years of retained earnings and the workings of compound interest.

If the widget company consistently earned a superior return on capital throughout the period, or if capital employed only doubled during the CEO's reign, the praise for him may be well deserved. But if return on capital was lackluster and capital employed increased in pace with earnings, applause should be withheld. A savings account in which interest was reinvested would achieve the same year-by-year increase in earnings - and, at only 8% interest, would quadruple its annual earnings in 18 years.

The power of this simple math is often ignored by companies to the detriment of their shareholders. 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.

An example will illustrate the inequities possible under such circumstances. Let's suppose that you had a $100,000 savings account earning 8% interest and "managed" by a trustee who could decide each year what portion of the interest you were to be paid in cash. Interest not paid out would be "retained earnings" added to the savings account to compound. And let's suppose that your trustee, in his superior wisdom, set the "pay-out ratio" at one-quarter of the annual earnings.

Under these assumptions, your account would be worth $179,084 at the end of ten years. Additionally, your annual earnings would have increased about 70% from $8,000 to $13,515 under this inspired management. And, finally, your "dividends" would have increased commensurately, rising regularly from $2,000 in the first year to $3,378 in the tenth year. Each year, when your manager's public relations firm prepared his annual report to you, all of the charts would have had lines marching skyward.

Now, just for fun, let's push our scenario one notch further and give your trustee-manager a ten-year fixed-price option on part of your "business" (i.e., your savings account) based on its fair value in the first year. With such an option, your manager would reap a substantial profit at your expense - just from having held on to most of your earnings. If he were both Machiavellian and a bit of a mathematician, your manager might also have cut the pay-out ratio once he was firmly entrenched.

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This scenario is not as farfetched as you might think. 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.

Managers actually apply a double standard to options. Leaving aside warrants (which deliver the issuing corporation immediate and substantial compensation), I believe it is fair to say that nowhere in the business world are ten-year fixed-price options on all or a portion of a business granted to outsiders. Ten months, in fact, would be regarded as extreme. It would be particularly unthinkable for managers to grant a long-term option on a business that was regularly adding to its capital. Any outsider wanting to secure such an option would be required to pay fully for capital added during the option period.

The unwillingness of managers to do-unto-outsiders, however, is not matched by an unwillingness to do-unto-themselves. (Negotiating with one's self seldom produces a barroom brawl.) 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.

Of course, stock options often go to talented, value-adding managers and sometimes deliver them rewards that are perfectly appropriate. (Indeed, managers who are really exceptional almost always get far less than they should.) But when the result is equitable, it is accidental. Once granted, the option is blind to individual performance. Because it is irrevocable and unconditional (so long as a manager stays in the company), the sluggard receives rewards from his options precisely as does the star. A managerial Rip Van Winkle, ready to doze for ten years, could not wish for a better "incentive" system.

> *"Diversification is a protection against ignorance. [It] makes very little sense for those who know what they are doing."*
>
> *Warren Buffett*

(I can't resist commenting on one long-term option given an "outsider": that granted the U.S. Government on Chrysler shares as partial consideration for the government's guarantee of some lifesaving loans. When these options worked out well for the government, Chrysler sought to modify the payoff, arguing that the rewards to the government were both far greater than intended and outsize in relation to its contribution to Chrysler's recovery. The company's anguish over what it saw as an imbalance between payoff and performance made national news. That anguish may well be unique: to my knowledge, no managers - anywhere - have been similarly offended by unwarranted payoffs arising from options granted to themselves or their colleagues.)

Ironically, the rhetoric about options frequently describes them as desirable because they put managers and owners in the same financial boat. In reality, the boats are far different. No owner has ever escaped the burden of capital costs, whereas a holder of a fixed-price option bears no capital costs at all. 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.)

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Child Care Benefit docIn dividend policy also, the option holders' interests are best served by a policy that may ill serve the owner. Think back to the savings account example. The trustee, holding his option, would benefit from a no-dividend policy. Conversely, the owner of the account should lean to a total payout so that he can prevent the option-holding manager from sharing in the account's retained earnings.

Despite their shortcomings, options can be appropriate under some circumstances. My criticism relates to their indiscriminate use and, in that connection, I would like to emphasize three points:

First, stock options are inevitably tied to the overall performance of a corporation. Logically, therefore, they should be awarded only to those managers with overall responsibility. Managers with limited areas of responsibility should have incentives that pay off in relation to results under their control. The .350 hitter expects, and also deserves, a big payoff for his performance - even if he plays for a cellar-dwelling team. And the .150 hitter should get no reward - even if he plays for a pennant winner. Only those with overall responsibility for the team should have their rewards tied to its results.

Second, options should be structured carefully. Absent special factors, they should have built into them a retained-earnings or carrying-cost factor.Equally important, they should be priced realistically. When managers are faced with offers for their companies, they unfailingly point out how unrealistic market prices can be as an index of real value. But why, then, should these same depressed prices be the valuations at which managers sell portions of their businesses to themselves? (They may go further: officers and directors sometimes consult the Tax Code to determine the lowest prices at which they can, in effect, sell part of the business to insiders. While they're at it, they often elect plans that produce the worst tax result for the company.) Except in highly unusual cases, owners are not wellserved by the sale of part of their business at a bargain price - whether the sale is to outsiders or to insiders. The obvious conclusion: options should be priced at true business value.

Third, I want to emphasize that some managers whom I admire enormously - and whose operating records are far better than mine - disagree with me regarding fixed-price options. They have built corporate cultures that work, and fixed-price options have been a tool that helped them. By their leadership and example, and by the use of options as incentives, these managers have taught their colleagues to think like owners. Such a Culture is rare and when it exists should perhaps be left intact - despite inefficiencies and inequities that may infest the option program. "If it ain't broke, don't fix it" is preferable to "purity at any price".

At Berkshire, however, we use an incentive@ compensation system that rewards key managers for meeting targets in their own bailiwicks. If See's does well, that does not produce incentive compensation at the News - nor vice versa. Neither do we look at the price of Berkshire stock when we write bonus checks. We believe good unit performance should be rewarded whether Berkshire stock rises, falls, or stays even. Similarly, we think average performance should earn no special rewards even if our stock should soar. "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.

The rewards that go with this system can be large. At our various business units, top managers sometimes receive incentive bonuses of five times their base salary, or more, and it would appear possible that one manager's bonus could top $2 million in 1986.(I hope so.) We do not put a cap on bonuses, and the potential for rewards is not hierarchical. The manager of a relatively small unit can earn far more than the

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manager of a larger unit if results indicate he should. We believe, further, that such factors as seniority and age should not affect incentive compensation (though they sometimes influence basic compensation). A 20-year-old who can hit .300 is as valuable to us as a 40-year-old performing as well.

Obviously, all Berkshire managers can use their bonus money (or other funds, including borrowed money) to buy our stock in the market. Many have done just that - and some now have large holdings. By accepting both the risks and the carrying costs that go with outright purchases, these managers truly walk in the shoes of owners.

Now let's get back - at long last - to our three businesses:

At Nebraska Furniture Mart our basic strength is an exceptionally low-cost operation that allows the business to regularly offer customers the best values available in home furnishings. NFM is the largest store of its kind in the country. Although the already-depressed farm economy worsened considerably in 1985, the store easily set a new sales record. I also am happy to report that NFM's Chairman, Rose Blumkin (the legendary "Mrs. B"), continues at age 92 to set a pace at the store that none of us can keep up with. She's there wheeling anddealing seven days a week, and I hope that any of you who visit Omaha will go out to the Mart and see her in action. It will inspire you, as it does me.

At See's we continue to get store volumes that are far beyond those achieved by any competitor we know of. Despite the unmatched consumer acceptance we enjoy, industry trends are not good, and we continue to experience slippage in poundage sales on a same-store basis. This puts pressure on per-pound costs. We now are willing to increase prices only modestly and, unless we can stabilize per-shop poundage, profit margins will narrow.

> *"The business schools reward difficult complex behavior more than simple behavior, but simple behavior is more effective."*
>
> *Warren Buffett*

At the News volume gains are also difficult to achieve. Though linage increased during 1985, the gain was more than accounted for by preprints. ROP linage (advertising printed on our own pages) declined. Preprints are far less profitable than ROP ads, and also more vulnerable to competition. In 1985, the News again controlled costs well and our household penetration continues to be exceptional.

One problem these three operations do not have is management. At See's we have Chuck Huggins, the man we put in charge the day we bought the business. Selecting him remains one of our best business decisions. At the News we have Stan Lipsey, a manager of equal caliber. Stan has been with us 17 years, and his unusual business talents have become more evident with every additional level of responsibility he has tackled. And, at the Mart, we have the amazing Blumkins - Mrs. B, Louie, Ron, Irv, and Steve - a three-generation miracle of management.

I consider myself extraordinarily lucky to be able to work with managers such as these. I like them personally as much as I admire them professionally.

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Insurance Operations

Shown below is an updated version of our usual table, listing two key figures for the insurance industry:

	Yearly Change in Premiums Written (%)	Combined Ratio after Policy-holder Dividends
1972	10.2	96.2
1973	8	99.2
1974	6.2	105.4
1975	11	107.9
1976	21.9	102.4
1977	19.8	97.2
1978	12.8	97.5
1979	10.3	100.6
1980	6	103.1
1981	3.9	106
1982	4.4	109.7
1983	4.5	111.9
1984 (Revised)	9.2	117.9
1985 (Estimated)	20.9	118

Source: Best's Aggregates and Averages

The combined ratio represents total insurance costs (losses incurred plus expenses) compared to revenue from premiums: a ratio below 100 indicates an underwriting profit, and one above 100 indicates a loss.

The industry's 1985 results were highly unusual. The revenue gain was exceptional, and had insured losses grown at their normal rate of most recent years - that is, a few points above the inflation rate - a significant drop in the combined ratio would have occurred. But losses in 1985 didn't cooperate, as they did not in 1984. Though inflation slowed considerably in these years, insured losses perversely accelerated, growing by 16% in 1984 and by an even more startling 17% in 1985. The year's growth in losses therefore exceeds the inflation rate by over 13 percentage points, a modern record.

Catastrophes were not the culprit in this explosion of loss cost. True, there were an unusual number of hurricanes in 1985, but the aggregate damage caused by all catastrophes in 1984 and 1985 was about 2% of premium volume, a not unusual proportion. Nor was there any burst in the number of insured autos, houses, employers, or other kinds of "exposure units".

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.

A more disturbing ingredient in the loss surge is the acceleration in "social" or "judicial" inflation. The insurer's ability to pay has assumed overwhelming importance with juries and judges in the assessment of both liability and damages. More and more, "the deep pocket" is being sought and found, no matter what the policy wording, the facts, or the precedents.

This judicial inflation represents a wild card in the industry's future, and makes forecasting difficult. Nevertheless, the short-term outlook is good. Premium growth improved as 1985 went along (quarterly gains were an estimated 15%, 19%, 24%, and 22%) and, barring a supercatastrophe, the industry's combined ratio should fall sharply in 1986.

The profit improvement, however, is likely to be of short duration. Two economic principles will see to that. 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.

In my 1982 report to you, I discussed the commodity nature of the insurance industry

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extensively. The typical policyholder does not differentiate between products but concentrates instead on price. For many decades a cartel-like procedure kept prices up, but this arrangement has disappeared for good. The insurance product now is priced as any other commodity for which a free market exists: when capacity is tight, prices will be set remuneratively; otherwise, they will not be.

Capacity currently is tight in many lines of insurance - though in this industry, unlike most, capacity is an attitudinal concept, not a physical fact. Insurance managers can write whatever amount of business they feel comfortable writing, subject only to pressures applied by regulators and Best's, the industry's authoritative rating service. The comfort level of both managers and regulators is tied to capital. More capital means more comfort, which in turn means more capacity. In 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.

That's exactly what's going on right now. In 1985, about 15 insurers raised well over $3 billion, piling up capital so that they can write all the business possible at the better prices now available. The capital-raising trend has accelerated dramatically so far in 1986.

If capacity additions continue at this rate, it won't be long before serious price-cutting appears and next a fall in profitability. When the fall comes, it will be the fault of the capital-raisers of 1985 and 1986, not the price-cutters of 198X. (Critics should be understanding, however: as was the case in our textile example, the dynamics of capitalism cause each insurer to make decisions that for itself appear sensible, but that collectively slash profitability.)

In past reports, I have told you that Berkshire's strong capital position - the best in the industry - should one day allow us to claim a distinct competitive advantage in the insurance market. With the tightening of the market, that day arrived. Our premium volume more than tripled last year, following a long period of stagnation. Berkshire's financial strength (and our record of maintaining unusual strength through thick and thin) is now a major asset for us in securing good business.

We correctly foresaw a flight to quality by many large buyers of insurance and reinsurance who belatedly recognized that a policy is only an IOU - and who, in 1985, could not collect on many of their IOUs. These buyers today are attracted to Berkshire because of its strong capital position. But, in a development we did not foresee, we also are finding buyers drawn to us because our ability to insure substantial risks sets us apart from the crowd.

To understand this point, you need a few background facts about large risks. Traditionally, many insurers have wanted to write this kind of business. However, their willingness to do so has been almost always based upon reinsurance arrangements that allow the insurer to keep just a small portion of the risk itself while passing on ("laying off") most of the risk to its reinsurers. Imagine, for example, a directors and officers ("D & O") liability policy providing $25 million of coverage. By various "excess-of-loss" reinsurance contracts, the company issuing that policy might keep the liability for only the first $1 million of any loss that occurs. The liability for any loss above that amount up to $24 million would be borne by the reinsurers of the issuing insurer. In trade parlance, a company that issues large policies but retains relatively little of the risk for its own account writes a large gross line but a small net line.

In any reinsurance arrangement, a key question is how the premiums paid for the policy should be divided among the various "layers" of risk. In our D &O policy, for example. what part of the premium received should be kept by the issuing

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company to compensate it fairly for taking the first $1 million of risk and how much should be passed on to the reinsurers to compensate them fairly for taking the risk between $1 million and $25 million?

One way to solve this problem might be deemed the Patrick Henry approach: "I have but one lamp by which my feet are guided, and that is the lamp of experience." In other words, how much of the total premium would reinsurers have needed in the past to compensate them fairly for the losses they actually had to bear?

Unfortunately, the lamp of experience has always provided imperfect illumination for reinsurers because so much of their business is "long-tail", meaning it takes many years before they know what their losses are. 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."

The burgeoning uncertainties of the business, coupled with the entry into reinsurance of many unsophisticated participants, worked in recent years in favor of issuing companies writing a small net line: they were able to keep a far greater percentage of the premiums than the risk. By doing so, the issuing companies sometimes made money on business that was distinctly unprofitable for the issuing and reinsuring companies combined. (This result was not necessarily by intent: issuing companies generally knew no more than reinsurers did about the ultimate costs that would be experienced at higher layers of risk.) 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 & 0, 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.

An example of just how disparate results have been for issuing companies versus their reinsurers is provided by the 1984 financials of one of the leaders in large and unusual risks. In that year the company wrote about $6 billion of business and kept around $2 1/2 billion of the premiums, or about 40%. It gave the remaining $3 1/2 billion to reinsurers. 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.

A few years such as this, and even slow-witted reinsurers can lose interest, particularly in explosive lines where the proper split in premium between issuer and reinsurer remains impossible to even roughly estimate. The behavior of reinsurers finally becomes like that of Mark Twain's cat: having once sat on a hot stove, it never did so again - but it never again sat on a cold stove, either. Reinsurers have had so many unpleasant surprises in long-tail casualty lines that many have decided (probably correctly) to give up the game entirely, regardless of price inducements. Consequently, there has been a dramatic pull-back of reinsurance capacity in certain important lines.

This development has left many issuing companies under pressure. They can no longer commit their reinsurers, time after time, for tens of millions per policy as they so easily could do

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only a year or two ago, and they do not have the capital and/or appetite to take on large risks for their own account. For many issuing companies, gross capacity has shrunk much closer to net capacity - and that is often small, indeed.

At Berkshire we have never played the lay-it-off-at-a-profit game and, until recently, that put us at a severe disadvantage in certain lines. Now the tables are turned: we have the underwriting capability whereas others do not. If we believe the price to be right, we are willing to write a net line larger than that of any but the largest insurers. For instance, we are perfectly willing to risk losing $10 million of our own money on a single event, as long as we believe that the price is right and that the risk of loss is not significantly correlated with other risks we are insuring. Very few insurers are willing to risk half that much on single events - although, just a short while ago, many were willing to lose five or ten times that amount as long as virtually all of the loss was for the account of their reinsurers.

In mid-1985 our largest insurance company, National Indemnity Company, broadcast its willingness to underwrite large risks by running an ad in three issues of an insurance weekly. The ad solicited policies of only large size: those with a minimum premium of $1 million. This ad drew a remarkable 600 replies and ultimately produced premiums totaling about $50 million. (Hold the applause: it's all long-tail business and it will be at least five years before we know whether this marketing success was also an underwriting success.) Today, our insurance subsidiaries continue to be sought out by brokers searching for large net capacity.

As I have said, this period of tightness will pass; insurers and reinsurers will return to underpricing. But for a year or two we should do well in several segments of our insurance business. Mike Goldberg has made many important improvements in the operation (prior mismanagement by your Chairman having provided him ample opportunity to do so). He has been particularly successful recently in hiring young managers with excellent potential. They will have a chance to show their stuff in 1986.

Our combined ratio has improved - from 134 in 1984 to 111 in 1985 - but continues to reflect past misdeeds. Last year I told you of the major mistakes I had made in loss-reserving, and promised I would update you annually on loss-development figures. Naturally, I made this promise thinking my future record would be much improved. So far this has not been the case. Details on last year's loss development are on pages 50-52. They reveal significant underreserving at the end of 1984, as they did in the several years preceding.

The only bright spot in this picture is that virtually all of the underreserving revealed in 1984 occurred in the reinsurance area - and there, in very large part, in a few contracts that were discontinued several years ago. This explanation, however, recalls all too well a story told me many years ago by the then Chairman of General Reinsurance Company. He said that every year his managers told him that "except for the Florida hurricane" or "except for Midwestern tornadoes", they would have had a terrific year. Finally he called the group together and suggested that they form a new operation - the Except-For Insurance Company - in which they would henceforth place all of the business that they later wouldn't want to count.

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.

Inevitably, of course, business errors will occur and the wise manager will try to find the proper lessons in them. But the trick is to learn most lessons from the experiences of others.

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Managers who have learned much from personal experience in the past usually are destined to learn much from personal experience in the future.

GEICO, 38%-owned by Berkshire, reported an excellent year in 1985 in premium growth and investment results, but a poor year - by its lofty standards - in underwriting. Private passenger auto and homeowners insurance were the only important lines in the industry whose results deteriorated significantly during the year. GEICO did not escape the trend, although its record was far better than that of virtually all its major competitors.

Jack Byrne left GEICO at mid-year to head Fireman's Fund, leaving behind Bill Snyder as Chairman and Lou Simpson as Vice Chairman. Jack's performance in reviving GEICO from near-bankruptcy was truly extraordinary, and his work resulted in enormous gains for Berkshire. We owe him a great deal for that.

We are equally indebted to Jack for an achievement that eludes most outstanding leaders: he found managers to succeed him who have talents as valuable as his own. By his skill in identifying, attracting and developing Bill and Lou, Jack extended the benefits of his managerial stewardship well beyond his tenure.

Fireman's Fund Quota-Share Contract

Never one to let go of a meal ticket, we have followed Jack Byrne to Fireman's Fund ("FFIC") where he is Chairman and CEO of the holding company.

On September 1, 1985 we became a 7% participant in all of the business in force of the FFIC group, with the exception of reinsurance they write for unaffiliated companies. Our contract runs for four years, and provides that our losses and costs will be proportionate to theirs throughout the contract period. If there is no extension, we will thereafter have no participation in any ongoing business. However, for a great many years in the future, we will be reimbursing FFIC for our 7% of the losses that occurred in the September 1, 1985 - August 31, 1989 period.

Under the contract FFIC remits premiums to us promptly and we reimburse FFIC promptly for expenses and losses it has paid. Thus, funds generated by our share of the business are held by us for investment. As part of the deal, I'm available to FFIC for consultation about general investment strategy. I'm not involved, however, in specific investment decisions of FFIC, nor is Berkshire involved in any aspect of the company's underwriting activities.

Currently FFIC is doing about $3 billion of business, and it will probably do more as rates rise. The company's September 1, 1985 unearned premium reserve was $1.324 billion, and it therefore transferred 7% of this, or $92.7 million, to us at initiation of the contract. We concurrently paid them $29.4 million representing the underwriting expenses that they had incurred on the transferred premium. All of the FFIC business is written by National Indemnity Company, but two-sevenths of it is passed along to Wesco-Financial Insurance Company ("Wes-FIC"), a new company organized by our 80%-owned subsidiary, Wesco Financial Corporation. Charlie Munger has some interesting comments about Wes-FIC and the reinsurance business on pages 60-62.

To the Insurance Segment tables on page 41, we have added a new line, labeled Major Quota Share Contracts. The 1985 results of the FFIC contract are reported there, though the newness of the arrangement makes these results only very rough approximations.

After the end of the year, we secured another quota-share contract, whose 1986 volume should be over $50 million. 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.

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Marketable Securities

We show below our 1985 yearend net holdings in marketable equities. All positions with a market value over $25 million are listed, and the interests attributable to minority shareholders of Wesco and Nebraska Furniture Mart are excluded.

No. of Shares		Cost	Market
		(000s omitted)	
1036461	Affiliated publications, Inc	$3,516	$55,710
900800	American Broadcasting Companies, Inc.	$54,435	$108,997
2350922	Beatrice Companies, Inc.	$106,811	$108,142
6850000	GEICO Corporation	$45,713	$595,950
2379200	Handy & Harman	$27,318	$43,718
847788	Time, Inc.	$20,385	$52,669
1727765	The Washington Post Company	$9,731	$205,172
		$267,909	$1,170,358
	All other Common Stockholdings	$7,201	$27,963
	Total Common Stocks	$275,110	$1,198,321

We mentioned earlier that in the past decade the investment environment has changed from one in which great businesses were totally unappreciated to one in which they are appropriately recognized. The Washington Post Company ("WPC") provides an excellent example.

We bought all of our WPC holdings in mid-1973 at a price of not more than one-fourth of the then per-share business value of the enterprise. Calculating the price/value ratio required no unusual insights. Most security analysts, media brokers, and media executives would have estimated WPC's intrinsic business value at $400 to $500 million just as we did. And its $100 million stock market valuation was published daily for all to see. Our advantage, rather, was attitude: we had learned from Ben Graham that the key to successful investing was the purchase of shares in good businesses when market prices were at a large discount from underlying business values.

Most institutional investors in the early 1970s, on the other hand, regarded business value as of only minor relevance when they were deciding the prices at which they would buy or sell. This now seems hard to believe. However, these institutions were then under the spell of academics at prestigious business schools who were preaching a newly-fashioned theory: the stock market was totally efficient, and therefore calculations of business value - and even thought, itself - were of no importance in investment activities. (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?)

Through 1973 and 1974, WPC continued to do fine as a business, and intrinsic value grew. Nevertheless, by yearend 1974 our WPC holding showed a loss of about 25%, with market value at $8 million against our cost of $10.6 million. What we had thought ridiculously cheap a year earlier had become a good bit cheaper as the market, in its infinite wisdom, marked WPC stock down to well below 20 cents on the dollar of intrinsic value.

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You know the happy outcome. Kay Graham, CEO of WPC, had the brains and courage to repurchase large quantities of stock for the company at those bargain prices, as well as the managerial skills necessary to dramatically increase business values. Meanwhile, investors began to recognize the exceptional economics of the business and the stock price moved closer to underlying value. Thus, we experienced a triple dip: the company's business value soared upward, per-share business value increased considerably faster because of stock repurchases and, with a narrowing of the discount, the stock price outpaced the gain in per-share business value.

We hold all of the WPC shares we bought in 1973, except for those sold back to the company in 1985's proportionate redemption. Proceeds from the redemption plus yearend market value of our holdings total $221 million.

If we had invested our $10.6 million in any of a half-dozen media companies that were investment favorites in mid-1973, the value of our holdings at yearend would have been in the area of $40 - $60 million. Our gain would have far exceeded the gain in the general market, an outcome reflecting the exceptional economics of the media business. The extra $160 million or so we gained through ownership of WPC came, in very large part, from the superior nature of the managerial decisions made by Kay as compared to those made by managers of most media companies. Her stunning business success has in large part gone unreported but among Berkshire shareholders it should not go unappreciated.

Our Capital Cities purchase, described in the next section, required me to leave the WPC Board early in 1986. But we intend to hold indefinitely whatever WPC stock FCC rules allow us to. We expect WPC's business values to grow at a reasonable rate, and we know that management is both able and shareholder-oriented. However, the market now values the company at over $1.8 billion, and there is no way that the value can progress from that level at a rate anywhere close to the rate possible when the company's valuation was only $100 million. Because market prices have also been bid up for our other holdings, we face the same vastly-reduced potential throughout our portfolio.

You will notice that we had a significant holding in Beatrice Companies at yearend. This is a short-term arbitrage holding - in effect, a parking place for money (though not a totally safe one, since deals sometimes fall through and create substantial losses). We sometimes enter the arbitrage field when we have more money than ideas, but only to participate in announced mergers and sales. We would be a lot happier if the funds currently employed on this short-term basis found a long-term home. At the moment, however, prospects are bleak.

At yearend our insurance subsidiaries had about $400 million in tax-exempt bonds, of which $194 million at amortized cost were issues of Washington Public Power Supply System ("WPPSS") Projects 1, 2, and 3. 1 discussed this position fully last year, and explained why we would not disclose further purchases or sales until well after the fact (adhering to the policy we follow on stocks). Our unrealized gain on the WPPSS bonds at yearend was $62 million, perhaps one-third arising from the upward movement of bonds generally, and the remainder from a more positive investor view toward WPPSS 1, 2, and 3s. Annual tax-exempt income from our WPPSS issues is about $30 million.

Capital Cities/ABC, Inc.

Right after yearend, Berkshire purchased 3 million shares of Capital Cities/ABC, Inc. ("Cap Cities") at $172.50 per share, the market price of such shares at the time the commitment was made early in March, 1985. I've been on record for many years about the management of Cap Cities: I think it is the best of any publicly-owned company in the country. And Tom Murphy and Dan Burke are not only great managers, they are precisely the sort of fellows that you would want

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your daughter to marry. It is a privilege to be associated with them - and also a lot of fun, as any of you who know them will understand.

Our purchase of stock helped Cap Cities finance the $3.5 billion acquisition of American Broadcasting Companies. For Cap Cities, ABC is a major undertaking whose economics are likely to be unexciting over the next few years. This bothers us not an iota; we can be very patient. (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.)

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.

Since large blocks frequently command premium prices, some might think we have injured Berkshire financially by creating such restrictions. Our view is just the opposite. We feel the long-term economic prospects for these businesses - and, thus, for ourselves as owners - are enhanced by the arrangements. With them in place, the first-class managers with whom we have aligned ourselves can focus their efforts entirely upon running the businesses and maximizing long-term values for owners. Certainly this is much better than having those managers distracted by "revolving-door capitalists" hoping to put the company "in play". (Of course, some managers place their own interests above those of the company and its owners and deserve to be shaken up - but, in making investments, we try to steer clear of this type.)

Today, corporate instability is an inevitable consequence of widely-diffused ownership of voting stock. At any time a major holder can surface, usually mouthing reassuring rhetoric but frequently harboring uncivil intentions. By circumscribing our blocks of stock as we often do, we intend to promote stability where it otherwise might be lacking. That kind of certainty, combined with a good manager and a good business, provides excellent soil for a rich financial harvest. That's the economic case for our arrangements.

The human side is just as important. We don't want managers we like and admire - and who have welcomed a major financial commitment by us - to ever lose any sleep wondering whether surprises might occur because of our large ownership. I have told them there will be no surprises, and these agreements put Berkshire's signature where my mouth is. That signature also means the managers have a corporate commitment and therefore need not worry if my personal participation in Berkshire's affairs ends prematurely (a term I define as any age short of three digits).

Our Cap Cities purchase was made at a full price, reflecting the very considerable enthusiasm for both media stocks and media properties that has developed in recent years (and that, in the case of some property purchases, has approached a mania) it's no field for bargains. However, our Cap Cities investment allies us with an exceptional combination of properties and people - and we like the opportunity to participate in size.

Of course, some of you probably wonder why we are now buying Cap Cities at $172.50 per share given that your Chairman, in a characteristic burst of brilliance, sold Berkshire's holdings in the same company at $43 per share in 1978-80. Anticipating your question, I spent much of 1985 working on a snappy answer that would reconcile these acts.

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Warren Buffett's Letter to Shareholders March 1986 cont'd

A little more time, please.

Acquisition of Scott & Fetzer

Right after yearend we acquired The Scott & Fetzer Company ("Scott Fetzer") of Cleveland for about $320 million. (In addition, about $90 million of pre-existing Scott Fetzer debt remains in place.) In the next section of this report I describe the sort of businesses that we wish to buy for Berkshire. Scott Fetzer is a prototype - understandable, large, well-managed, a good earner.

The company has sales of about $700 million derived from 17 businesses, many leaders in their fields. Return on invested capital is good to excellent for most of these businesses. Some well-known products are Kirby home-care systems, Campbell Hausfeld air compressors, and Wayne burners and water pumps.

World Book, Inc. - accounting for about 40% of Scott Fetzer's sales and a bit more of its income - is by far the company's largest operation. It also is by far the leader in its industry, selling more than twice as many encyclopedia sets annually as its nearest competitor. In fact, it sells more sets in the U.S. than its four biggest competitors combined.

Charlie and I have a particular interest in the World Book operation because we regard its encyclopedia as something special. I've been a fan (and user) for 25 years, and now have grandchildren consulting the sets just as my children did. World Book is regularly rated the most useful encyclopedia by teachers, librarians and consumer buying guides. Yet it sells for less than any of its major competitors. Childcraft, another World Book, Inc. product, offers similar value. This combination of exceptional products and modest prices at World Book, Inc. helped make us willing to pay the price demanded for Scott Fetzer, despite declining results for many companies in the direct-selling industry.

An equal attraction at Scott Fetzer is Ralph Schey, its CEO for nine years. When Ralph took charge, the company had 31 businesses, the result of an acquisition spree in the 1960s. He disposed of many that did not fit or had limited profit potential, but his focus on rationalizing the original potpourri was not so intense that he passed by World Book when it became available for purchase in 1978. Ralph's operating and capital-allocation record is superb, and we are delighted to be associated with him.

The history of the Scott Fetzer acquisition is interesting, marked by some zigs and zags before we became involved. The company had been an announced candidate for purchase since early 1984. A major investment banking firm spent many months canvassing scores of prospects, evoking interest from several. Finally, in mid-1985 a plan of sale, featuring heavy participation by an ESOP (Employee Stock Ownership Plan), was approved by shareholders. However, as difficulty in closingfollowed, the plan was scuttled.

I had followed this corporate odyssey through the newspapers. On October 10, well after the ESOP deal had fallen through, I wrote a short letter to Ralph, whom I did not know. I said we admired the company's record and asked if he might like to talk. Charlie and I met Ralph for dinner in Chicago on October 22 and signed an acquisition contract the following week.

The Scott Fetzer acquisition, plus major growth in our insurance business, should push revenues above $2 billion in 1986, more than double those of 1985.

Miscellaneous

The Scott Fetzer purchase illustrates our somewhat haphazard approach to acquisitions. We have no master strategy, no corporate planners delivering us insights about socioeconomic trends, and no staff to investigate a multitude of ideas presented by promoters and intermediaries. Instead, we simply hope that something sensible comes along - and, when it does, we act.

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To give fate a helping hand, we again repeat our regular "business wanted" ad. The only change from last year's copy is in (1): because we continue to want any acquisition we make to have a measurable impact on Berkshire's financial results, we have raised our minimum profit requirement.

Here's what we're looking for:

(1) large purchases (at least $10 million of after-tax earnings),

(2) demonstrated consistent earning power (future projections are of little interest to us, nor are "turn-around" situations),

(3) businesses earning good returns on equity while employing little or no debt,

(4) management in place (we can't supply it),

(5) simple businesses (if there's lots of technology, we won't understand it),

(6) an offering price (we don't want to waste our time or that of the seller by talking, even preliminarily, about a transaction when price is unknown).

We will not engage in unfriendly takeovers. We can promise complete confidentiality and a very fast answer - customarily within five minutes - as to whether we're interested. We prefer to buy for cash, but will consider issuance of stock when we receive as much in intrinsic business value as we give. Indeed, following recent advances in the price of Berkshire stock, transactions involving stock issuance may be quite feasible. We invite potential sellers to check us out by contacting people with whom we have done business in the past. For the right business - and the right people - we can provide a good home.

On the other hand, we frequently get approached about acquisitions that don't come close to meeting our tests: 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.

* * *

Besides being interested in the purchases of entire businesses as described above, we are also interested in the negotiated purchase of large, but not controlling, blocks of stock, as in our Cap Cities purchase. 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.

* * *

About 96.8% of all eligible shares participated in Berkshire's 1985 shareholder-designated contributions program. Total contributions made through the program were $4 million, and 1,724 charities were recipients. We conducted a plebiscite last year in order to get your views about this program, as well as about our dividend policy. (Recognizing that it's possible to influence the answers to a question by the framing of it, we attempted to make the wording of ours as neutral as possible.) We present the ballot and the results in the Appendix on page 69. I think it's fair to summarize your response as highly supportive of present policies and your group preference - allowing for the tendency of people to vote for the status quo - to be for increasing the annual charitable commitment as our asset values build.

We urge new shareholders to read the description of our shareholder-designated contributions program that appears on pages 66 and 67. If you wish to participate in future programs, we strongly urge that you immediately make sure that your shares are registered in the name of the actual owner, not in "street" name or nominee name. Shares not so registered on September 30, 1986 will be ineligible for the 1986 program.

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Warren Buffett's Letter to Shareholders March 1986 cont'd

* * *

Five years ago we were required by the Bank Holding Company Act of 1969 to dispose of our holdings in The Illinois National Bank and Trust Company of Rockford, Illinois. Our method of doing so was unusual: we announced an exchange ratio between stock of Rockford Bancorp Inc. (the Illinois National's holding company) and stock of Berkshire, and then let each of our shareholders - except me - make the decision as to whether to exchange all, part, or none of his Berkshire shares for Rockford shares. I took the Rockford stock that was left over and thus my own holding in Rockford was determined by your decisions. At the time I said, "This technique embodies the world's oldest and most elementary system of fairly dividing an object. Just as when you were a child and one person cut the cake and the other got first choice, I have tried to cut the company fairly, but you get first choice as to which piece you want."

Last fall Illinois National was sold. When Rockford's liquidation is completed, its shareholders will have received per-share proceeds about equal to Berkshire's per-share intrinsic value at the time of the bank's sale. I'm pleased that this five-year result indicates that the division of the cake was reasonably equitable.

Last year I put in a plug for our annual meeting, and you took me up on the invitation. Over 250 of our more than 3,000 registered shareholders showed up. Those attending behaved just as those present in previous years, asking the sort of questions you would expect from intelligent and interested owners. You can attend a great many annual meetings without running into a crowd like ours.(Lester Maddox, when Governor of Georgia, was criticized regarding the state's abysmal prison system. "The solution", he said, "is simple. All we need is a better class of prisoners." Upgrading annual meetings works the same way.)

I hope you come to this year's meeting, which will be held on May 20 in Omaha. There will be only one change: after 48 years of allegiance to another soft drink, your Chairman, in an unprecedented display of behavioral flexibility, has converted to the new Cherry Coke. Henceforth, it will be the Official Drink of the Berkshire Hathaway Annual Meeting.

And bring money: Mrs. B promises to have bargains galore if you will pay her a visit at The Nebraska Furniture Mart after the meeting.

Warren E. Buffett
Chairman of the Board
March 4, 1986

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