

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 September 2011 edition of Leyland Lines.

The market continues to be volatile and extremely focussed on Greece. This fear has pushed equity prices lower and company p/e ratios are now at levels not seen for over 20 years. Yields are also improving as company earnings, for the most part, improved during the August 2011 reporting season. As much as earnings grow, the market is failing to recognise this in share prices. 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. Prior to the GFC, the market was trading at an all-time high, debt was abundant and strong balance sheets were considered 'lazy'; this is far removed from today with corporate balance sheets as strong as they have been in 50 years with 27% gearing versus 50% historically.

Whilst the turmoil in Europe is not to be ignored, investors should be trying to look past the short term and if they are comfortable with the earnings of the businesses they own (or are considering purchasing), they need to decide whether they prefer to buy now when things are cheap or at more expensive prices when things look "clearer".

Readers of Leyland Lines will know our answer to this question.

There are many clichés in the investment market; many of which seem to be tools for stockbrokers to extract orders from clients...the two most common (and contradictory) are "you can't go broke taking a profit" and "cut your losses; let your profits run". Another meaningless but poetic cliché is "sell in May and go away". Every investor seems to have their favourite, the worrying aspect is when investors use these glib comments as reasons to undertake a transaction.

However, there are some sensible and relevant clichés, including "buy straw hats in winter"; "buy in gloom; sell in boom" and "nobody wants to buy water tanks when it is raining".

Whilst these sentiments make a lot of sense on face value, "buying in gloom" is very difficult for most investors to achieve. Gloomy times are often associated with negative press and a general feeling of fear – investors tend to get caught like rabbits in a headlight.

# Leyland Lines

One of the keys to value investing is to try and unwind the natural human tendencies of fear and greed, and instead to remain focussed on the fundamentals. This is just the time.

In this edition of Leyland Lines we discuss Domino's Pizza, Cochlear and Flight Centre. As in all of our newsletters we are not necessarily recommending that investors purchase these companies. If you would like to discuss our favourite companies for investment please contact Leyland Private Asset Management.

We also include Warren Buffett's 1984 letter to shareholders.



## Jarrod Saffy at Leyland Private Asset Management

Readers may be aware that Leyland Private Asset Management employs Melbourne Rebels rugby player Jarrod Saffy on a part time basis. The Melbourne Rebels have a five star pledge in which they are involved in a charity, business, school and local rugby club.

ABC television filmed a story in which Jarrod and a number of other players discuss their five star pledges and their life outside rugby.

<http://www.youtube.com/watch?v=FAhshHcwMLS>

## Cochlear (COH)

Price: \$47.26

Market Cap: \$2.74b

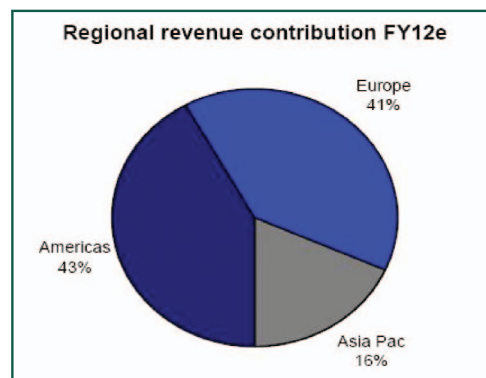
Cochlear pioneered and is the global leader in the research and development, manufacture and marketing of implantable hearing solutions. Cochlear's global headquarters are located on the campus of Macquarie University in Sydney to enable links to world leading hearing science research.

A success story in the commercialisation of R&D, Cochlear has a 70% share of the global market, employs 2,000 people worldwide, operates directly in over 20 countries and sells in over 100 countries.

Cochlear implants have been used principally to help profoundly hearing impaired (PHI) recipients (i.e., those with no useful hearing) however, more recently, also the severely hearing impaired (SHI, i.e., those with some residual hearing). Over 200,000 people now experience hearing as a recipient of a Cochlear hearing solution.

The company has three products as follows:

- **Nucleus (current version called Nucleus 5)** are implants which help people with moderate to profound hearing loss in both ears;
- **Baha** are bone conduction implants which can help people with single-sided deafness and certain types of conductive or mixed hearing loss;
- **Hybrid** which are electroacoustic implants which can help people with high frequency hearing loss.



MARKET UPDATE

# Leyland Lines

## Cochlear cont'd

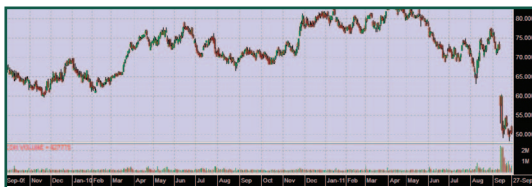
### Event

On September 11, the company reported that its Nucleus 5 (N5) system had experienced a recent increase in implant failures and in order to find out why, Cochlear voluntarily issued a recall of unimplanted devices. The company could not provide guidance on a likely market return date. Production has switched to the previous Nucleus model known as Freedom (c. 2005), which they intend to sell instead of N5 in order to attempt to defend market share. It will more than likely take at least one month before Freedom units will be released in significant quantities.

This announcement is extremely significant as it is the first time in Cochlear's history that they have had to recall a device which has both marred their pristine production and development record, and comes at a time when their main competitors are in a position to challenge their market dominance.

The company's two main competitors are Advanced Bionics (AB) and MED-EL. AB received US FDA approval to recommence marketing the HiRes 90k cochlear implant (CI) on September 13, 2011. AB, having been re-admitted to the EU in May 2011, has inventory ready for the US relaunch. MED-EL announced US FDA approval of its new MAESTRO Cochlear Implant System in mid-September 2011.

As a result of the recall announcement, Cochlear's share price has been savaged, down approximately 35%, wiping in excess of 1 billion dollars off their market capitalisation.



### Outlook

There is a distinct lack of clarity as to when N5 might return to the market. If the return can be expedited (i.e., the problem is simple and can be back in market without manufacturing variation), then there is greater chance of minimising market

share loss. However a prolonged return provokes the following complications:

- Distraction from 'normal' sales growth activity;
- New costs and margin impact (manufacturing and discounts);
- Potential contract expiries or renegotiations.

When taking in to account the above, combined with the company's two main competitors imminent return to the market- place (notably via AB re-entering the US market) and potential tightening of re-imbusement criteria in developed Europe, a definite case of fallibility in Cochlear's fortunes does appear to be developing.

On the positive side of the ledger, the company's Return on Equity is still at approximately 35% with the potential to head higher depending on how much free cash the company chooses to hand back to shareholders. Management under CEO Dr Chris Roberts has outstanding strategic vision and execution ability and with the FY 2011 result, the company has become debt-free. The current weakness in the Australian dollar is also positive should the trend continue.

Once a 'market darling', this recall has put a severe dent in the market's once almost unshakeable confidence in Cochlear. As such, it is doubtful the market will continue to be willing to pay a premium (current P/E of 18.25X for 2012). Whilst still no question a high-quality operation, the company can ill-afford any further setbacks and is still expensive on valuation grounds. With this in mind, we would take a cautious view to purchasing shares until such time as further guidance regarding a return of N5 and how their competitor's progress is evidenced.

COH \$49.67	2010 A	2011 A	2012 E	2013 E	2014 E
EPS (cps)	278.20	316.75	287.58	330.41	366.09
PE (x)	17.85	15.68	15.71	13.67	12.34
DPS (cps)	200.00	225.00	245.05	253.33	272.62
Yield (%)	4.03%	4.53%	4.93%	5.10%	5.49%
Franking (%)	73%	71%	69%	70%	70%

# Leyland Lines

## Flight Centre (FLT)

Price: \$16.64

Market Cap: \$1.70b

Flight centre is a travel agent with a network of over 2,200 stores and 6,400 staff globally. Nearly half of the stores are located off-shore. In Australia, the company enjoys the highest retail market share and a contribution of 80% of EBIT. Internationally, all 10 countries were profitable for the first time.



### FY11 Results

NPAT of \$170m up 22% year-on-year was driven primarily by stronger out-bound demand in Australia.

All countries were profitable for the first time. Flight Centre in India, China and Canada also enjoyed improved profits. The US became profitable during the period (\$1.5m EBIT). However, the UK profitability was below expectations with significantly deteriorating earnings.

Margins decreased from 14.3% to 13.8% due to reduced income margins from:

- (1) Corporates: Lower fees and mark-ups
- (2) Leisure: Value focused customers coupled with the fuel surcharge

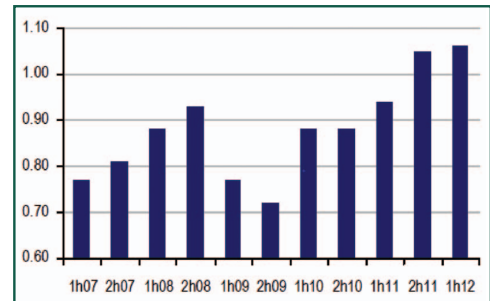
### Operating Conditions

Corporate accounts for 30% of Flight Centre's earnings. Growth of 17% in this segment continues to outpace leisure at 7%. Flight Centre has historically added 3%-5% new stores per annum.

The higher oil price has resulted in airlines imposing an 'oil surcharge', impacting demand, especially leisure.

Competition from online does not seem to affect Flight Centre who have enjoyed an increase in Total Transaction Value (TTV) of 12%, and margins at close to record levels.

The higher AUD has resulted in strong growth in international travel. Average AUD/USD yearly comparison as follows;



### Guidance

Management have maintained guidance of 10% growth. However, with volatility in offshore markets and soft consumer sentiment in Australia, there remains down-side risk to this figure.

### Balance Sheet & Dividend

Flight Centre has a net cash position of \$209m or \$2.11 per share allowing for potential capital management or further acquisitions. The company is well placed to withstand external shocks.

Flight Centre is regulated to hold a significant amount of cash for licencing purposes.

A final fully franked dividend of 48cps was declared. Management has increased the pay-out ratio to 84%, up from 70%.

### Summary

As highlighted by the following numbers, the current share price ascribes a near flat growth rate for the foreseeable future – notwithstanding guidance of 10% growth. Flat growth forecasts may be justified given the global turmoil and negative sentiment.

### 2012 estimates

P/E	EPS	DPS	Yield	Franking	EPS Growth
9.0x	\$1.83	\$1.23	7.20%	100%	8%

Flight Centre enjoys a strong market position with branding to match, a strong balance sheet and leverage to improving conditions.

On a forward P/E of 9x and yielding about 7% fully franked, much of the down-side appears to be captured in the share price, which has fallen from \$25 in January to \$17 today.

# Leyland Lines

## Domino's Pizza (DMP)

**Price: \$6.95**

**Market Cap: \$480m**

Dominos is certainly 'flavour of the month', and in the interest of market research I recently joined the throng of people starting a diet....tomorrow.

In Australia DMP enjoys 46% of market share and 36% in New Zealand. These two markets account for ~85% of sales with Europe making up the balance. Online sales account for 40% of total sales with DMP increasingly becoming an online/technology company.



At the risk of stating what most people already know, Dominos offers value-for-money junk food – pizza, pasta, deserts and soft drinks. Given NPAT growth of 20%, an online strategy including an iPhone application, and defensive characteristics Dominos had outperformed the broader ASX200 by ~30% over the past year.

Whilst we appreciate this is a terrific company with strong management and a robust strategy, how much of a premium to the market does it deserve?

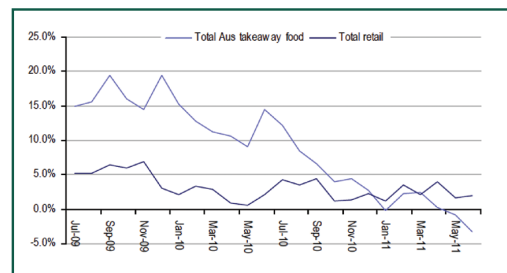
At present, Domino's is trading at 19x 2012 earnings or a 70% premium to the market on 11x. Given that perfection is rarely achieved, it is difficult to develop an investment case at current levels. However, we will monitor DMP and review our position on weakness in the share price.

### FY2011 Result

DMP reported NPAT of \$21.4m, up 20% year-on-year. Guidance of 15% NPAT growth in this financial year was provided and should be easily achievable given aggressive promotional activity and menu pipeline.

During the period, 43 new stores were opened with Dominos acquiring a number of existing franchises, and splitting then into two territories. Management expects an additional 60 to 70 new stores to open this FY.

The defensive characteristic of the take-away food sector is highlighted in the following chart.



### Balance Sheet

DMP has a net cash balance of \$12.5m Cash flow was strong, with operating cash up 51% yoy to \$36m. The company also enjoyed EBITDA margin expansion of ~20% reflecting strong sales on a fixed cost base.

### Strategy

Online sales now account for 40% of total sales. A user-friendly iPhone application has largely contributed to this. With newer technology entering the market constantly and Dominos strategy allows for significant leverage to this trend.

### Comps versus Peers

Domino's trades in line with global peers (which provide the best comparisons).

	P/E	EV/ EBITDA	EPS Growth
Dominos (Aust)	19x	9.7x	20%
McDonalds (US)	15x	9.2x	12%
Starbucks (US)	19x	9.7x	24%

# Leyland Lines

## Berkshire Hathaway Inc.

### To the Shareholders of Berkshire Hathaway Inc.:

This past year our registered shareholders increased from about 1900 to about 2900. Most of this growth resulted from our merger with Blue Chip Stamps, but there also was an acceleration in the pace of "natural" increase that has raised us from the 1000 level a few years ago.

With so many new shareholders, it's appropriate to summarize the major business principles we follow that pertain to the manager-owner relationship:

Although our form is corporate, our attitude is partnership. Charlie Munger and I think of our shareholders as owner-partners, and of ourselves as managing partners. (Because of the size of our shareholdings we also are, for better or worse, controlling partners.) We do not view the company itself as the ultimate owner of our business assets but, instead, view the company as a conduit through which our shareholders own the assets.

In line with this owner-orientation, our directors are all major shareholders of Berkshire Hathaway. In the case of at least four of the five, over 50% of family net worth is represented by holdings of Berkshire. We eat our own cooking.

Our long-term economic goal (subject to some qualifications mentioned later) is to maximize the average annual rate of gain in intrinsic business value on a per-share basis. We do not measure the economic significance or performance of Berkshire by its size; we measure by per-share progress. We are certain that the rate of per-share progress will diminish in the future - a greatly enlarged capital base will see to that. But we will be disappointed if our rate does not exceed that of the average large American corporation.

Our preference would be to reach this goal by directly owning a diversified group of businesses that generate cash and consistently earn above-average returns on capital. Our second choice

is to own parts of similar businesses, attained primarily through purchases of marketable common stocks by our insurance subsidiaries. The price and availability of businesses and the need for insurance capital determine any given year's capital allocation.

Because of this two-pronged approach to business ownership and because of the limitations of conventional accounting, consolidated reported earnings may reveal relatively little about our true economic performance. Charlie and I, both as owners and managers, virtually ignore such consolidated numbers. However, we will also report to you the earnings of each major business we control, numbers we consider of great importance. These figures, along with other information we will supply about the individual businesses, should generally aid you in making judgments about them.

Accounting consequences do not influence our operating or capital-allocation decisions. When acquisition costs are similar, we much prefer to purchase \$2 of earnings that is not reportable by us under standard accounting principles than to purchase \$1 of earnings that is reportable. This is precisely the choice that often faces us since entire businesses (whose earnings will be fully reportable) frequently sell for double the pro-rata price of small portions (whose earnings will be largely unreportable). In aggregate and over time, we expect the unreported earnings to be fully reflected in our intrinsic business value through capital gains.

We rarely use much debt and, when we do, we attempt to structure it on a long-term fixed rate basis. We will reject interesting opportunities rather than over-leverage our balance sheet. This conservatism has penalized our results but it is the only behavior that leaves us comfortable, considering our fiduciary obligations to policyholders, depositors, lenders and the many equity holders who have committed unusually large portions of their net worth to our care.

# Leyland Lines

## Berkshire Hathaway Inc. cont'd

A managerial "wish list" will not be filled at shareholder expense. We will not diversify by purchasing entire businesses at control prices that ignore long-term economic consequences to our shareholders. We will only do with your money what we would do with our own, weighing fully the values you can obtain by diversifying your own portfolios through direct purchases in the stock market.

We feel noble intentions should be checked periodically against results. We test the wisdom of retaining earnings by assessing whether retention, over time, delivers shareholders at least \$1 of market value for each \$1 retained. To date, this test has been met. We will continue to apply it on a five-year rolling basis. As our net worth grows, it is more difficult to use retained earnings wisely.

We will issue common stock only when we receive as much in business value as we give. This rule applies to all forms of issuance - not only mergers or public stock offerings, but stock-for-debt swaps, stock options, and convertible securities as well. We will not sell small portions of your company - and that is what the issuance of shares amounts to - on a basis inconsistent with the value of the entire enterprise.

You should be fully aware of one attitude Charlie and I share that hurts our financial performance: regardless of price, we have no interest at all in selling any good businesses that Berkshire owns, and are very reluctant to sell sub-par businesses as long as we expect them to generate at least some cash and as long as we feel good about their managers and labor relations. We hope not to repeat the capital-allocation mistakes that led us into such sub-par businesses. And we react with great caution to suggestions that our poor businesses can be restored to satisfactory profitability by major capital expenditures. (The projections will be dazzling - the advocates will be sincere - but, in the end, major additional investment in a terrible industry usually is about as rewarding as struggling in quicksand.)

*"The fact that people will be full of greed, fear or folly is predictable. The sequence is not predictable."*

*Warren Buffett*

Nevertheless, gin rummy managerial behavior (discard your least promising business at each turn) is not our style. We would rather have our overall results penalized a bit than engage in it.

We will be candid in our reporting to you, emphasizing the pluses and minuses important in appraising business value. Our guideline is to tell you the business facts that we would want to know if our positions were reversed. We owe you no less. Moreover, as a company with a major communications business, it would be inexcusable for us to apply lesser standards of accuracy, balance and incisiveness when reporting on ourselves than we would expect our news people to apply when reporting on others. We also believe candor benefits us as managers: the CEO who misleads others in public may eventually mislead himself in private.

Despite our policy of candor, we will discuss our activities in marketable securities only to the extent legally required. Good investment ideas are rare, valuable and subject to competitive appropriation just as good product or business acquisition ideas are. Therefore, we normally will not talk about our investment ideas. This ban extends even to securities we have sold (because we may purchase them again) and to stocks we are incorrectly rumored to be buying. If we deny those reports but say "no comment" on other occasions, the no-comments become confirmation.

That completes the catechism, and we can now move on to the high point of 1983 - the

# Leyland Lines

## Berkshire Hathaway Inc. cont'd

acquisition of a majority interest in Nebraska Furniture Mart and our association with Rose Blumkin and her family.

### Nebraska Furniture Mart

Last year, in discussing how managers with bright, but adrenalin-soaked minds scramble after foolish acquisitions, I quoted Pascal: "It has struck me that all the misfortunes of men spring from the single cause that they are unable to stay quietly in one room."

Even Pascal would have left the room for Mrs. Blumkin.

About 67 years ago Mrs. Blumkin, then 23, talked her way past a border guard to leave Russia for America. She had no formal education, not even at the grammar school level, and knew no English. After some years in this country, she learned the language when her older daughter taught her, every evening, the words she had learned in school during the day.

In 1937, after many years of selling used clothing, Mrs. Blumkin had saved \$500 with which to realize her dream of opening a furniture store. Upon seeing the American Furniture Mart in Chicago - then the center of the nation's wholesale furniture activity - she decided to christen her dream Nebraska Furniture Mart.

She met every obstacle you would expect (and a few you wouldn't) when a business endowed with only \$500 and no locational or product advantage goes up against rich, long-entrenched competition. At one early point, when her tiny resources ran out, "Mrs. B" (a personal trademark now as well recognized in Greater Omaha as Coca-Cola or Sanka) coped in a way not taught at business schools: she simply sold the furniture and appliances from her home in order to pay creditors precisely as promised.

Omaha retailers began to recognize that Mrs. B would offer customers far better deals than they had been giving, and they pressured furniture and carpet manufacturers not to sell to her. But

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

*Warren Buffett*

by various strategies she obtained merchandise and cut prices sharply. Mrs. B was then hauled into court for violation of Fair Trade laws.

She not only won all the cases, but received invaluable publicity. At the end of one case, after demonstrating to the court that she could profitably sell carpet at a huge discount from the prevailing price, she sold the judge \$1400 worth of carpet.

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

One question I always ask myself in appraising a business is how I would like, assuming I had ample capital and skilled personnel, to compete with it. I'd rather wrestle grizzlies than compete with Mrs. B and her progeny. They buy brilliantly, they operate at expense ratios competitors don't even dream about, and they then pass on to their customers much of the savings. It's the ideal business - one built upon exceptional value to the customer that in turn translates into exceptional economics for its owners.

Mrs. B is wise as well as smart and, for far-sighted family reasons, was willing to sell the business last year. I had admired both the family and the business for decades, and a deal was quickly made. But Mrs. B, now 90, is not one to go home and risk, as she puts it, "losing her

# Leyland Lines

## Berkshire Hathaway Inc. cont'd

marbles". She remains Chairman and is on the sales floor seven days a week. Carpet sales are her specialty. She personally sells quantities that would be a good departmental total for other carpet retailers.

We purchased 90% of the business - leaving 10% with members of the family who are involved in management - and have optioned 10% to certain key young family managers.

And what managers they are. Geneticists should do handsprings over the Blumkin family. Louie Blumkin, Mrs. B's son, has been President of Nebraska Furniture Mart for many years and is widely regarded as the shrewdest buyer of furniture and appliances in the country. Louie says he had the best teacher, and Mrs. B says she had the best student. They're both right. Louie and his three sons all have the Blumkin business ability, work ethic, and, most important, character. On top of that, they are really nice people. We are delighted to be in partnership with them.

### Corporate Performance

During 1983 our book value increased from \$737.43 per share to \$975.83 per share, or by 32%. We never take the one-year figure very seriously. After all, why should the time required for a planet to circle the sun synchronize precisely with the time required for business actions to pay off? Instead, we recommend not less than a five-year test as a rough yardstick of economic performance. Red lights should start flashing if the five-year average annual gain falls much below the return on equity earned over the period by American industry in aggregate. (Watch out for our explanation if that occurs as Goethe observed, "When ideas fail, words come in very handy.")

During the 19-year tenure of present management, book value has grown from \$19.46 per share to \$975.83, or 22.6% compounded annually. Considering our present size, nothing close to this rate of return can be sustained.

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

*Warren Buffett*

Those who believe otherwise should pursue a career in sales, but avoid one in mathematics.

We report our progress in terms of book value because in our case (though not, by any means, in all cases) it is a conservative but reasonably adequate proxy for growth in intrinsic business value - the measurement that really counts. Book value's virtue as a score-keeping measure is that it is easy to calculate and doesn't involve the subjective (but important) judgments employed in calculation of intrinsic business value. It is important to understand, however, that the two terms - book value and intrinsic business value - have very different meanings.

Book value is an accounting concept, recording the accumulated financial input from both contributed capital and retained earnings. Intrinsic business value is an economic concept, estimating future cash output discounted to present value. Book value tells you what has been put in; intrinsic business value estimates what can be taken out.

An analogy will suggest the difference. Assume you spend identical amounts putting each of two children through college. The book value (measured by financial input) of each child's education would be the same. But the present value of the future payoff (the intrinsic business value) might vary enormously - from zero to many times the cost of the education. So, also, do businesses having equal financial input end up with wide variations in value.

# Leyland Lines

## Berkshire Hathaway Inc. cont'd

At Berkshire, at the beginning of fiscal 1965 when the present management took over, the \$19.46 per share book value considerably overstated intrinsic business value. All of that book value consisted of textile assets that could not earn, on average, anything close to an appropriate rate of return. In the terms of our analogy, the investment in textile assets resembled investment in a largely-wasted education.

Now, however, our intrinsic business value considerably exceeds book value. There are two major reasons:

- (1) Standard accounting principles require that common stocks held by our insurance subsidiaries be stated on our books at market value, but that other stocks we own be carried at the lower of aggregate cost or market. At the end of 1983, the market value of this latter group exceeded carrying value by \$70 million pre-tax, or about \$50 million after tax. This excess belongs in our intrinsic business value, but is not included in the calculation of book value;
- (2) More important, we own several businesses that possess economic Goodwill (which is properly includable in intrinsic business value) far larger than the accounting Goodwill that is carried on our balance sheet and reflected in book value.

Goodwill, both economic and accounting, is an arcane subject and requires more explanation than is appropriate here. The appendix that follows this letter - "Goodwill and its Amortization: The Rules and The Realities" - explains why economic and accounting Goodwill can, and usually do, differ enormously.

You can live a full and rewarding life without ever thinking about Goodwill and its amortization. But students of investment and management should understand the nuances of the subject. My own thinking has changed drastically from 35 years ago when I was taught to favor tangible assets and to shun businesses whose value depended largely upon economic Goodwill. This bias caused

me to make many important business mistakes of omission, although relatively few of commission.

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

I recommend the Appendix to those who are comfortable with accounting terminology and who have an interest in understanding the business aspects of Goodwill. Whether or not you wish to tackle the Appendix, you should be aware that Charlie and I believe that Berkshire possesses very significant economic Goodwill value above that reflected in our book value.

### Sources of Reported Earnings

The table below shows the sources of Berkshire's reported earnings. In 1982, Berkshire owned about 60% of Blue Chip Stamps whereas, in 1983, our ownership was 60% throughout the first six months and 100% thereafter. In turn, Berkshire's net interest in Wesco was 48% during 1982 and the first six months of 1983, and 80% for the balance of 1983. Because of these changed ownership percentages, the first two columns of the table provide the best measure of underlying business performance.

All of the significant gains and losses attributable to unusual sales of assets by any of the business entities are aggregated with securities transactions on the line near the bottom of the table, and are not included in operating earnings. (We regard any annual figure for realized capital gains or losses as meaningless, but we regard the aggregate realized and unrealized capital gains over a period of years as very important.) Furthermore, amortization of Goodwill is not charged against the specific businesses but, for reasons outlined in the Appendix, is set forth as a separate item.

# Leyland Lines

## Berkshire Hathaway Inc. cont'd

	Earnings Before Income Taxes				Net Earnings After Tax	
	Total		Berkshire Share		Berkshire Share	
	1983	1982	1983	1982	1983	1982
(in thousands of dollars)						
Operating earnings						
Insurance Group:						
Underwriting	\$(33,872)	\$(21,558)	\$(33,872)	\$(21,558)	\$(18,400)	\$(11,345)
Net Investment Income	\$43,810	\$41,620	\$43,810	\$41,620	\$39,114	\$35,270
Berkshire-Waumbec textiles	\$(100)	\$(1,545)	\$(100)	\$(1,545)	\$(63)	\$862
Associated Retail Stores, Inc.	\$697	\$914	\$697	\$914	\$355	\$446
Nebraska Furniture Mart <sup>(1)</sup>	\$3,812	--	\$3,049	--	\$1,521	--
See's Candies	\$27,411	\$23,884	\$24,526	\$14,235	\$12,212	\$6,914
Buffalo Evening News	\$19,352	\$(1,215)	\$16,547	\$(724)	\$8,832	\$(226)
Blue Chip Stamps <sup>(2)</sup>	\$(1,422)	\$4,182	\$(1,876)	\$2,492	\$(353)	\$2,472
Wesco Financial Corporation - Parent	\$7,493	\$6,156	\$4,844	\$2,937	\$3,448	\$2,210
Mutual Savings and Loan Association	\$(798)	\$(6)	\$(467)	\$(2)	\$1,917	\$1,524
Precision Steel	\$3,241	\$1,035	\$2,102	\$493	\$1,136	\$265
Interest on Debt	\$15,104	\$(14,996)	\$13,844	\$(12,977)	\$7,346	\$6,951
Special GEICO Distribution	\$21,000	--	\$21,000	--	\$19,551	
Shareholder Designated Contributions	\$(3,066)	\$(891)	\$(3,066)	\$(891)	\$(1,656)	\$(481)
Amortization of Goodwill	\$(532)	\$151	\$(563)	\$90	\$(563)	\$90
Other*	\$10,121	\$3,371	\$9,623	\$2,658	\$8,490	\$2,171
Operationing earnings	\$82,043	\$41,102	\$72,410	\$27,742	\$68,195	\$31,497
Sales of securities and unusual sales of assets	\$67,260	\$36,651	\$65,089	\$21,875	\$45,298	\$14,877
Total Earnings	\$149,303	\$77,753	\$137,499	\$49,617	\$113,493	\$46,374

(1) October through December

(2) 1982 and 1983 are not comparable; major assets were transferred in the merger.

# Leyland Lines

## Berkshire Hathaway Inc. cont'd

For a discussion of the businesses owned by Wesco, please read Charlie Munger's report on pages 46-51. Charlie replaced Louie Vincenti as Chairman of Wesco late in 1983 when health forced Louie's retirement at age 77. In some instances, "health" is a euphemism, but in Louie's case nothing but health would cause us to consider his retirement. Louie is a marvelous man and has been a marvelous manager.

The special GEICO distribution reported in the table arose when that company made a tender offer for a portion of its stock, buying both from us and other shareholders. At GEICO's request, we tendered a quantity of shares that kept our ownership percentage the same after the transaction as before. The proportional nature of our sale permitted us to treat the proceeds as a dividend. Unlike individuals, corporations net considerably more when earnings are derived from dividends rather than from capital gains, since the effective Federal income tax rate on dividends is 6.9% versus 28% on capital gains.

Even with this special item added in, our total dividends from GEICO in 1983 were considerably less than our share of GEICO's earnings. Thus it is perfectly appropriate, from both an accounting and economic standpoint, to include the redemption proceeds in our reported earnings. It is because the item is large and unusual that we call your attention to it.

The table showing you our sources of earnings includes dividends from those non-controlled companies whose marketable equity securities we own. But the table does not include earnings those companies have retained that are applicable to our ownership. In aggregate and over time we expect those undistributed earnings to be reflected in market prices and to increase our intrinsic business value on a dollar-for-dollar basis, just as if those earnings had been under our control and reported as part of our profits. That does not mean we expect all of our holdings to behave uniformly; some will disappoint us, others will deliver pleasant surprises. To date our experience

has been better than we originally anticipated. In aggregate, we have received far more than a dollar of market value gain for every dollar of earnings retained.

The following table shows our 1983 yearend net holdings in marketable equities. All numbers represent 100% of Berkshire's holdings, and 80% of Wesco's holdings. The portion attributable to minority shareholders of Wesco has been excluded.

No. of Shares		Cost	Market
		(000s omitted)	
690975	Affiliated publications, Inc	\$3,516	\$26,603
4451544	General Foods, Inc. <sup>(a)</sup>	\$163,786	\$228,698
6850000	GEICO Corporation	\$47,138	\$398,156
2379200	Handy & Harman	\$27,318	\$42,231
636310	Interpublic Group of Companies, Inc.	\$4,056	\$33,088
197200	Media General	\$3,191	\$11,191
250400	Ogilvy & Mather International Inc.	\$2,580	\$12,833
5618661	R. J. Reynolds Industries, Inc. <sup>(a)</sup>	\$268,918	\$314,334
901788	Time, Inc.	\$27,732	\$56,860
1868600	The Washington Post Company	\$10,628	\$136,875
		\$558,863	\$1,287,869
	All other Common Stockholdings	\$7,485	\$18,044
	Total Common Stocks	\$566,348	\$1,305,913

(a) WESCO owns shares in these companies.

Based upon present holdings and present dividend rates -

excluding any special items such as the GEICO proportional redemption last year - we would expect reported dividends from this group to be approximately \$39 million in 1984. We can also make a very rough guess about the earnings this group will retain that will be attributable to our

# Leyland Lines

## Berkshire Hathaway Inc. cont'd

ownership: these may total about \$65 million for the year. These retained earnings could well have no immediate effect on market prices of the securities. Over time, however, we feel they will have real meaning.

In addition to the figures already supplied, information regarding the businesses we control appears in Management's Discussion on pages 40-44. The most significant of these are Buffalo Evening News, See's, and the Insurance Group, to which we will give some special attention here.

### Buffalo Evening News

First, a clarification: our corporate name is Buffalo Evening News, Inc. but the name of the newspaper, since we began a morning edition a little over a year ago, is Buffalo News.

In 1983 the News somewhat exceeded its targeted profit margin of 10% after tax. Two factors were responsible: (1) a state income tax cost that was subnormal because of a large loss carry-forward, now fully utilized, and (2) a large drop in the per-ton cost of newsprint (an unanticipated fluke that will be reversed in 1984).

Although our profit margins in 1983 were about average for newspapers such as the News, the paper's performance, nevertheless, was a significant achievement considering the economic and retailing environment in Buffalo.

Buffalo has a concentration of heavy industry, a segment of the economy that was hit particularly hard by the recent recession and that has lagged the recovery. As Buffalo consumers have suffered, so also have the paper's retailing customers. Their numbers have shrunk over the past few years and many of those surviving have cut their lineage.

Within this environment the News has one exceptional strength: its acceptance by the public, a matter measured by the paper's "penetration ratio" - the percentage of households within the community purchasing the paper each day. Our ratio is superb: for the six months ended September 30, 1983 the News stood number one

in weekday penetration among the 100 largest papers in the United States (the ranking is based on "city zone" numbers compiled by the Audit Bureau of Circulations).

In interpreting the standings, it is important to note that many large cities have two papers, and that in such cases the penetration of either paper is necessarily lower than if there were a single paper, as in Buffalo. Nevertheless, the list of the 100 largest papers includes many that have a city to themselves. Among these, the News is at the top nationally, far ahead of many of the country's best-known dailies.

Among Sunday editions of these same large dailies, the News ranks number three in penetration - ten to twenty percentage points ahead of many well-known papers. It was not always this way in Buffalo. Below we show Sunday circulation in Buffalo in the years prior to 1977 compared with the present period. In that earlier period the Sunday paper was the Courier-Express (the News was not then publishing a Sunday paper). Now, of course, it is the News.

### Average Sunday Circulation

Year	Circulation
1970	314000
1971	306000
1972	302000
1973	290000
1974	278000
1975	269000
1976	270000
1984 (Current)	376000

We believe a paper's penetration ratio to be the best measure of the strength of its franchise. Papers with unusually high penetration in the geographical area that is of prime interest to major local retailers, and with relatively little circulation elsewhere, are exceptionally efficient buys for those retailers. Low-penetration papers have a far less compelling message to present to advertisers.

# Leyland Lines

## Berkshire Hathaway Inc. cont'd

In our opinion, three factors largely account for the unusual acceptance of the News in the community. Among these, points 2 and 3 also may explain the popularity of the Sunday News compared to that of the Sunday Courier-Express when it was the sole Sunday paper:

- (1) The first point has nothing to do with merits of the News. Both emigration and immigration are relatively low in Buffalo. A stable population is more interested and involved in the activities of its community than is a shifting population - and, as a result, is more interested in the content of the local daily paper. Increase the movement in and out of a city and penetration ratios will fall.
- (2) The News has a reputation for editorial quality and integrity that was honed by our longtime editor, the legendary Alfred Kirchofer, and that has been preserved and extended by Murray Light. This reputation was enormously important to our success in establishing a Sunday paper against entrenched competition. And without a Sunday edition, the News would not have survived in the long run.
- (3) The News lives up to its name - it delivers a very unusual amount of news. During 1983, our "news hole" (editorial material - not ads) amounted to 50% of the newspaper's content (excluding preprinted inserts). Among papers that dominate their markets and that are of comparable or larger size, we know of only one whose news hole percentage exceeds that of the News. Comprehensive figures are not available, but a sampling indicates an average percentage in the high 30s. In other words, page for page, our mix gives readers over 25% more news than the typical paper. This news-rich mixture is by intent. Some publishers, pushing for higher profit margins, have cut their news holes during the past decade. We have maintained ours and will continue to do so. Properly written and edited, a full serving

*"Chains of habit are too light to be felt until they are too heavy to be broken."*

*Warren Buffett*

of news makes our paper more valuable to the reader and contributes to our unusual penetration ratio.

Despite the strength of the News' franchise, gains in ROP lineage (advertising printed within the newspaper pages as contrasted to preprinted inserts) are going to be very difficult to achieve. We had an enormous gain in preprints during 1983: lines rose from 9.3 million to 16.4 million, revenues from \$3.6 million to \$8.1 million. These gains are consistent with national trends, but exaggerated in our case by business we picked up when the Courier-Express closed.

On balance, the shift from ROP to preprints has negative economic implications for us. Profitability on preprints is less and the business is more subject to competition from alternative means of delivery. Furthermore, a reduction in ROP lineage means less absolute space devoted to news (since the news hole percentage remains constant), thereby reducing the utility of the paper to the reader.

Stan Lipsey became Publisher of the Buffalo News at midyear upon the retirement of Henry Urban. Henry never flinched during the dark days of litigation and losses following our introduction of the Sunday paper - an introduction whose wisdom was questioned by many in the newspaper business, including some within our own building. Henry is admired by the Buffalo business community, he's admired by all who worked for him, and he is admired by Charlie and me. Stan worked with Henry for several years, and has worked for Berkshire Hathaway since

# Leyland Lines

## Berkshire Hathaway Inc. cont'd

1969. He has been personally involved in all nuts-and-bolts aspects of the newspaper business from editorial to circulation. We couldn't do better.

### See's Candy Shops

The financial results at See's continue to be exceptional. The business possesses a valuable and solid consumer franchise and a manager equally valuable and solid.

In recent years See's has encountered two important problems, at least one of which is well on its way toward solution. That problem concerns costs, except those for raw materials. We have enjoyed a break on raw material costs in recent years though so, of course, have our competitors. One of these days we will get a nasty surprise in the opposite direction. In effect, raw material costs are largely beyond our control since we will, as a matter of course, buy the finest ingredients that we can, regardless of

changes in their price levels. We regard product quality as sacred.

But other kinds of costs are more controllable, and it is in this area that we have had problems. On a per-pound basis, our costs (not including those for raw materials) have increased in the last few years at a rate significantly greater than the increase in the general price level. It is vital to our competitive position and profit potential that we reverse this trend.

In recent months much better control over costs has been attained and we feel certain that our rate of growth in these costs in 1984 will be below the rate of inflation. This confidence arises out of our long experience with the managerial talents of Chuck Huggins. We put Chuck in charge the day we took over, and his record has been simply extraordinary, as shown by the following table:

52-53 Week Year Ended About December 31	Sales Revenue	Operating Profits After Taxes	Number of Pounds of Candy Sold	Number of Stores Open at Year End
1983	133531000	13699000	24651000	207
1982	123662000	11875000	24216000	202
1981	112578000	10779000	24052000	199
1980	97715000	7547000	24065000	191
1979	87314000	6330000	23985000	188
1978	73653000	6178000	22407000	182
1977	62886000	6154000	20921000	179
1976	56333000	5569000	20553000	173
1975	50492000	5132000	19134000	172
1974	41248000	3021000	17883000	170
1973	35050000	1940000	17813000	169
1972	31337000	2083000	16954000	167

The other problem we face, as the table suggests, is our recent inability to achieve meaningful gains in pounds sold. The industry has the same problem. But for many years we outperformed the industry in this respect and now we are not.

The poundage volume in our retail stores has been virtually unchanged each year for the past four, despite small increases every year in the number of shops (and in distribution expense as well). Of course, dollar volume has increased because we have raised prices significantly. But we regard the most important measure of retail

# Leyland Lines

## Berkshire Hathaway Inc. cont'd

trends to be units sold per store rather than dollar volume. On a same-store basis (counting only shops open throughout both years) with all figures adjusted to a 52-week year, poundage was down .8 of 1% during 1983. This small decline was our best same-store performance since 1979; the cumulative decline since then has been about 8%. Quantity-order volume, about 25% of our total, has plateaued in recent years following very large poundage gains throughout the 1970s.

We are not sure to what extent this flat volume - both in the retail shop area and the quantity order area - is due to our pricing policies and to what extent it is due to static industry volume, the recession, and the extraordinary share of market we already enjoy in our primary marketing area. Our price increase for 1984 is much more modest than has been the case in the past few years, and we hope that next year we can report better volume figures to you. But we have no basis to forecast these.

Despite the volume problem, See's strengths are many and important. In our primary marketing area, the West, our candy is preferred by an enormous margin to that of any competitor. In fact, we believe most lovers of chocolate prefer it to candy costing two or three times as much. (In candy, as in stocks, price and value can differ; price is what you give, value is what you get.) The quality of customer service in our shops - operated throughout the country by us and not by franchisees is every bit as good as the product. Cheerful, helpful personnel are as much a trademark of See's as is the logo on the box. That's no small achievement in a business that requires us to hire about 2000 seasonal workers. We know of no comparably-sized organization that betters the quality of customer service delivered by Chuck Huggins and his associates.

Because we have raised prices so modestly in 1984, we expect See's profits this year to be about the same as in 1983.

## Insurance - Controlled Operations

We both operate insurance companies and have a large economic interest in an insurance business we don't operate, GEICO. The results for all can be summed up easily: in aggregate, the companies we operate and whose underwriting results reflect the consequences of decisions that were my responsibility a few years ago, had absolutely terrible results. Fortunately, GEICO, whose policies I do not influence, simply shot the lights out. The inference you draw from this summary is the correct one. I made some serious mistakes a few years ago that came home to roost.

The industry had its worst underwriting year in a long time, as indicated by the table below:

	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	4.6	111

Source: Best's Aggregates and Averages.

Best's data reflect the experience of practically the entire industry, including stock, mutual, and reciprocal companies. 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.

# Leyland Lines

## Berkshire Hathaway Inc. cont'd

For the reasons outlined in last year's report, we expect the poor industry experience of 1983 to be more or less typical for a good many years to come. (As Yogi Berra put it: "It will be deja vu all over again.") That doesn't mean we think the figures won't bounce around a bit; they are certain to. But we believe it highly unlikely that the combined ratio during the balance of the decade will average significantly below the 1981-1983 level. Based on our expectations regarding inflation - and we are as pessimistic as ever on that front - industry premium volume must grow about 10% annually merely to stabilize loss ratios at present levels.

Our own combined ratio in 1983 was 121. Since Mike Goldberg recently took over most of the responsibility for the insurance operation, it would be nice for me if our shortcomings could be placed at his doorstep rather than mine. But unfortunately, as we have often pointed out, the insurance business has a long lead-time. Though business policies may be changed and personnel improved, a significant period must pass before the effects are seen. (This characteristic of the business enabled us to make a great deal of money in GEICO; we could picture what was likely to happen well before it actually occurred.) So the roots of the 1983 results are operating and personnel decisions made two or more years back when I had direct managerial responsibility for the insurance group.

Despite our poor results overall, several of our managers did truly outstanding jobs. Roland Miller guided the auto and general liability business of National Indemnity Company and National Fire and Marine Insurance Company to improved results, while those of competitors deteriorated. In addition, Tom Rowley at Continental Divide Insurance - our fledgling Colorado homestate company - seems certain to be a winner. Mike found him a little over a year ago, and he was an important acquisition.

We have become active recently - and hope to become much more active - in reinsurance

*"Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down."*

*Warren Buffett*

transactions where the buyer's overriding concern should be the seller's long-term creditworthiness. In such transactions our premier financial strength should make us the number one choice of both claimants and insurers who must rely on the reinsurer's promises for a great many years to come.

A major source of such business is structured settlements - a procedure for settling losses under which claimants receive periodic payments (almost always monthly, for life) rather than a single lump sum settlement. This form of settlement has important tax advantages for the claimant and also prevents his squandering a large lump-sum payment. Frequently, some inflation protection is built into the settlement. Usually the claimant has been seriously injured, and thus the periodic payments must be unquestionably secure for decades to come. We believe we offer unparalleled security. No other insurer we know of - even those with much larger gross assets - has our financial strength.

We also think our financial strength should recommend us to companies wishing to transfer loss reserves. In such transactions, other insurance companies pay us lump sums to assume all (or a specified portion of) future loss payments applicable to large blocks of expired business. Here also, the company transferring such claims needs to be certain of the transferee's financial strength for many years to come. Again, most of our competitors soliciting

# Leyland Lines

## Berkshire Hathaway Inc. cont'd

such business appear to us to have a financial condition that is materially inferior to ours.

Potentially, structured settlements and the assumption of loss reserves could become very significant to us. Because of their potential size and because these operations generate large amounts of investment income compared to premium volume, we will show underwriting results from those businesses on a separate line in our insurance segment data. We also will exclude their effect in reporting our combined ratio to you. We "front end" no profit on structured settlement or loss reserve transactions, and all attributable overhead is expensed currently. Both businesses are run by Don Wurster at National Indemnity Company.

### Insurance - GEICO

Geico's performance during 1983 was as good as our own insurance performance was poor. Compared to the industry's combined ratio of 111, GEICO wrote at 96 after a large voluntary accrual for policyholder dividends. A few years ago I would not have thought GEICO could so greatly outperform the industry. Its superiority reflects the combination of a truly exceptional business idea and an exceptional management.

Jack Byrne and Bill Snyder have maintained extraordinary discipline in the underwriting area (including, crucially, provision for full and proper loss reserves), and their efforts are now being further rewarded by significant gains in new business. Equally important, Lou Simpson is the class of the field among insurance investment managers. The three of them are some team.

We have approximately a one-third interest in GEICO. That gives us a \$270 million share in the company's premium volume, an amount some 80% larger than our own volume. Thus, the major portion of our total insurance business comes from the best insurance book in the country. This fact does not moderate by an iota the need for us to improve our own operation.

### Stock Splits and Stock Activity

We often are asked why Berkshire does not split its stock. The assumption behind this question usually appears to be that a split would be a pro-shareholder action. We disagree. Let me tell you why.

One of our goals is to have Berkshire Hathaway stock sell at a price rationally related to its intrinsic business value. (But note "rationally related", not "identical": if well-regarded companies are generally selling in the market at large discounts from value, Berkshire might well be priced similarly.) The key to a rational stock price is rational shareholders, both current and prospective.

If the holders of a company's stock and/or the prospective buyers attracted to it are prone to make irrational or emotion-based decisions, some pretty silly stock prices are going to appear periodically. Manic-depressive personalities produce manic-depressive valuations. Such aberrations may help us in buying and selling the stocks of other companies. But we think it is in both your interest and ours to minimize their occurrence in the market for Berkshire.

To obtain only high quality shareholders is no cinch. Mrs. Astor could select her 400, but anyone can buy any stock. Entering members of a shareholder "club" cannot be screened for intellectual capacity, emotional stability, moral sensitivity or acceptable dress. Shareholder eugenics, therefore, might appear to be a hopeless undertaking.

In large part, however, we feel that high quality ownership can be attracted and maintained if we consistently communicate our business and ownership philosophy - along with no other conflicting messages - and then let self selection follow its course. For example, self selection will draw a far different crowd to a musical event advertised as an opera than one advertised as a rock concert even though anyone can buy a ticket to either.

# Leyland Lines

## Berkshire Hathaway Inc. cont'd

Through our policies and communications - our "advertisements" - we try to attract investors who will understand our operations, attitudes and expectations. (And, fully as important, we try to dissuade those who won't.) We want those who think of themselves as business owners and invest in companies with the intention of staying a long time. And, we want those who keep their eyes focused on business results, not market prices.

Investors possessing those characteristics are in a small minority, but we have an exceptional collection of them. I believe well over 90% - probably over 95% - of our shares are held by those who were shareholders of Berkshire or Blue Chip five years ago. And I would guess that over 95% of our shares are held by investors for whom the holding is at least double the size of their next largest. Among companies with at least several thousand public shareholders and more than \$1 billion of market value, we are almost certainly the leader in the degree to which our shareholders think and act like owners. Upgrading a shareholder group that possesses these characteristics is not easy.

Were we to split the stock or take other actions focusing on stock price rather than business value, we would attract an entering class of buyers inferior to the exiting class of sellers. At \$1300, there are very few investors who can't afford a Berkshire share. Would a potential one-share purchaser be better off if we split 100 for 1 so he could buy 100 shares? Those who think so and who would buy the stock because of the split or in anticipation of one would definitely downgrade the quality of our present shareholder group. (Could we really improve our shareholder group by trading some of our present

clear-thinking members for impressionable new ones who, preferring paper to value, feel wealthier with nine \$10 bills than with one \$100 bill?) People who buy for non-value reasons are likely to sell for non-value reasons. Their presence

in the picture will accentuate erratic price swings unrelated to underlying business developments.

We will try to avoid policies that attract buyers with a short-term focus on our stock price and try to follow policies that attract informed long-term investors focusing on business value. Just as you purchased your Berkshire shares in a market populated by rational informed investors, you deserve a chance to sell - should you ever want to - in the same kind of market. We will work to keep it in existence.

One of the ironies of the stock market is the emphasis on activity. Brokers, using terms such as "marketability" and "liquidity", sing the praises of companies with high share turnover (those who cannot fill your pocket will confidently fill your ear). But investors should understand that what is good for the croupier is not good for the customer. A hyperactive stock market is the pickpocket of enterprise.

For example, consider a typical company earning, say, 12% on equity. Assume a very high turnover rate in its shares of 100% per year. If a purchase and sale of the stock each extract commissions of 1% (the rate may be much higher on low-priced stocks) and if the stock trades at book value, the owners of our hypothetical company will pay, in aggregate, 2% of the company's net worth annually for the privilege of transferring ownership. This activity does nothing for the earnings of the business, and means that 1/6 of them are lost to the owners through the "frictional" cost of transfer. (And this calculation does not count option trading, which would increase frictional costs still further.)

All that makes for a rather expensive game of musical chairs. Can you imagine the agonized cry that would arise if a governmental unit were to impose a new 16 2/3% tax on earnings of corporations or investors? By market activity, investors can impose upon themselves the equivalent of such a tax.

# Leyland Lines

## Berkshire Hathaway Inc. cont'd

Days when the market trades 100 million shares (and that kind of volume, when over-the-counter trading is included, is today abnormally low) are a curse for owners, not a blessing - for they mean that owners are paying twice as much to change chairs as they are on a 50-million-share day. If 100 million-share days persist for a year and the average cost on each purchase and sale is 15 cents a share, the chair-changing tax for investors in aggregate would total about \$7.5 billion - an amount roughly equal to the combined 1982 profits of Exxon, General Motors, Mobil and Texaco, the four largest companies in the Fortune 500.

These companies had a combined net worth of \$75 billion at yearend 1982 and accounted for over 12% of both net worth and net income of the entire Fortune 500 list. Under our assumption investors, in aggregate, every year forfeit all earnings from this staggering sum of capital merely to satisfy their penchant for "financial flip-flopping". In addition, investment management fees of over \$2 billion annually - sums paid for chair-changing advice - require the forfeiture by investors of all earnings of the five largest banking organizations (Citicorp, Bank America, Chase Manhattan, Manufacturers Hanover and J. P. Morgan). These expensive activities may decide who eats the pie, but they don't enlarge it.

(We are aware of the pie-expanding argument that says that such activities improve the rationality of the capital allocation process. We think that this argument is specious and that, on balance, hyperactive equity markets subvert rational capital allocation and act as pie shrinkers. Adam Smith felt that all noncollusive acts in a free market were guided by an invisible hand that led an economy to maximum progress; our view is that casino-type markets and hair-trigger investment management act as an invisible foot that trips up and slows down a forward-moving economy.)

Contrast the hyperactive stock with Berkshire. The bid-and-ask spread in our stock currently is about 30 points, or a little over 2%. Depending on the size of the transaction, the difference between

proceeds received by the seller of Berkshire and cost to the buyer may range downward from 4% (in trading involving only a few shares) to perhaps 1 1/2% (in large trades where negotiation can reduce both the market-maker's spread and the broker's commission). Because most Berkshire shares are traded in fairly large transactions, the spread on all trading probably does not average more than 2%.

Meanwhile, true turnover in Berkshire stock (excluding inter-dealer transactions, gifts and bequests) probably runs 3% per year. Thus our owners, in aggregate, are paying perhaps 6/100 of 1% of Berkshire's market value annually for transfer privileges. By this very rough estimate, that's \$900,000 - not a small cost, but far less than average. Splitting the stock would increase that cost, downgrade the quality of our shareholder population, and encourage a market price less consistently related to intrinsic business value. We see no offsetting advantages.

### Miscellaneous

Last year in this section I ran a small ad to encourage acquisition candidates. In our communications businesses we tell our advertisers that repetition is a key to results (which it is), so we will again repeat our acquisition criteria.

We prefer:

- (1) large purchases (at least \$5 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).

# Leyland Lines

## Berkshire Hathaway Inc. cont'd

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. 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.

\* \* \* \* \*

About 96.4% of all eligible shares participated in our 1983 shareholder-designated contributions program. The total contributions made pursuant to this program - disbursed in the early days of 1984 but fully expensed in 1983 - were \$3,066,501, and 1353 charities were recipients. Although the response measured by the percentage of shares participating was extraordinarily good, the response measured by the percentage of holders participating was not as good. The reason may well be the large number of new shareholders acquired through the merger and their lack of familiarity with the program. We urge new shareholders to read the description of the program on pages 52-53.

If you wish to participate in future programs, we strongly urge that you immediately make sure that your shares are registered in the actual owner's name, not in "street" or nominee name. Shares not so registered on September 28, 1984 will not be eligible for any 1984 program.

\* \* \* \* \*

The Blue Chip/Berkshire merger went off without a hitch. Less than one-tenth of 1% of the shares of each company voted against the merger, and no requests for appraisal were made. In 1983, we gained some tax efficiency from the merger and we expect to gain more in the future.

One interesting sidelight to the merger: Berkshire now has 1,146,909 shares outstanding compared to 1,137,778 shares at the beginning of fiscal 1965, the year present management assumed responsibility. For every 1% of the company you owned at that time, you now would own .99%. Thus, all of today's assets - the News, See's, Nebraska Furniture Mart, the Insurance Group, \$1.3 billion in marketable stocks, etc. - have been added to the original textile assets with virtually no net dilution to the original owners.

We are delighted to have the former Blue Chip shareholders join us. To aid in your understanding of Berkshire Hathaway, we will be glad to send you the Compendium of Letters from the Annual Reports of 1977-1981, and/or the 1982 Annual report. Direct your request to the Company at 1440 Kiewit Plaza, Omaha, Nebraska 68131.

March 14, 1984

Warren E. Buffett  
Chairman of the Board

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