

Analysis by Vishal K. (safalniveshak.com) 26/2/19

Berkshire's Performance vs. the S&P 500

Few Imp. Lessons -

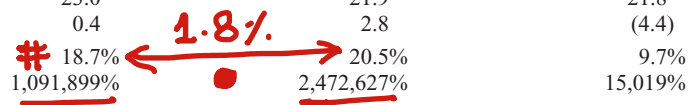
Year

	Annual Percentage Change		
	in Per-Share Book Value of Berkshire *	in Per-Share Market Value of Berkshire	in S&P 500 with Dividends Included
1965	23.8	49.5	10.0
1966	20.3	(3.4)	(11.7)
1967	11.0	13.3	30.9
1968	19.0	77.8	11.0
1969	16.2	19.4	(8.4)
1970	12.0	(4.6)	3.9
1971	16.4	80.5	14.6
1972	21.7	8.1	18.9
1973	4.7	(2.5)	(14.8)
1974	5.5	(48.7)	(26.4)
1975	21.9	2.5	37.2
1976	59.3	129.3	23.6
1977	31.9	46.8	(7.4)
1978	24.0	14.5	6.4
1979	35.7	102.5	18.2
1980	19.3	32.8	32.3
1981	31.4	31.8	(5.0)
1982	40.0	38.4	21.4
1983	32.3	69.0	22.4
1984	13.6	(2.7)	6.1
1985	48.2	93.7	31.6
1986	26.1	14.2	18.6
1987	19.5	4.6	5.1
1988	20.1	59.3	16.6
1989	44.4	84.6	31.7
1990	7.4	(23.1)	(3.1)
1991	39.6	35.6	30.5
1992	20.3	29.8	7.6
1993	14.3	38.9	10.1
1994	13.9	25.0	1.3
1995	21.1	57.4	37.6
1996	31.8	6.2	23.0
1997	34.1	34.9	33.4
1998	48.3	52.2	28.6
1999	0.5	(19.9)	21.0
2000	6.5	26.6	(9.1)
2001	(6.2)	6.5	(11.9)
2002	10.0	(3.8)	(22.1)
2003	21.0	15.8	28.7
2004	10.5	4.3	10.9
2005	6.4	0.8	4.9
2006	18.4	24.1	15.8
2007	11.0	28.7	5.5
2008	(9.6)	(31.8)	(37.0)
2009	19.8	2.7	26.5
2010	13.0	21.4	15.1
2011	4.6	(4.7)	2.1
2012	14.4	16.8	16.0
2013	18.2	32.7	32.4
2014	8.3	27.0	13.7
2015	6.4	(12.5)	1.4
2016	10.7	23.4	12.0
2017	23.0	21.9	21.8
2018	0.4	2.8	(4.4)
Compounded Annual Gain - 1965-2018	# 18.7%	20.5%	9.7%
Overall Gain - 1964-2018	1,091,899%	2,472,627%	15,019%

* Book value is a crude replacement of a business' intrinsic value. Over the long run, market value tracks intrinsic value closely, like it has done for Berkshire. Book value and market value may diverge for few years, but converge over the long term.

You don't need super-normal returns to create wealth. You need reasonable return and a long life.

• Small difference of 1.8% over 54 years creates difference of nearly "1.5 million" percentage! That's the power of long-term compounding. Believe in it!



Note: Data are for calendar years with these exceptions: 1965 and 1966, year ended 9/30; 1967, 15 months ended 12/31. Starting in 1979, accounting rules required insurance companies to value the equity securities they hold at market rather than at the lower of cost or market, which was previously the requirement. In this table, Berkshire's results through 1978 have been restated to conform to the changed rules. In all other respects, the results are calculated using the numbers originally reported. The S&P 500 numbers are pre-tax whereas the Berkshire numbers are after-tax. If a corporation such as Berkshire were simply to have owned the S&P 500 and accrued the appropriate taxes, its results would have lagged the S&P 500 in years when that index showed a positive return, but would have exceeded the S&P 500 in years when the index showed a negative return. Over the years, the tax costs would have caused the aggregate lag to be substantial.

Difference of 1.5 million percent!

BERKSHIRE HATHAWAY INC.

To the Shareholders of Berkshire Hathaway Inc.:

Berkshire earned \$4.0 billion in 2018 utilizing generally accepted accounting principles (commonly called “GAAP”). The components of that figure are \$24.8 billion in operating earnings, a \$3.0 billion non-cash loss from an impairment of intangible assets (arising almost entirely from our equity interest in Kraft Heinz), \$2.8 billion in realized capital gains from the sale of investment securities and a \$20.6 billion *loss* from a reduction in the amount of unrealized capital gains that existed in our investment holdings.

A new GAAP rule requires us to include that last item in earnings. As I emphasized in the 2017 annual report, neither Berkshire’s Vice Chairman, Charlie Munger, nor I believe that rule to be sensible. Rather, both of us have consistently thought that at Berkshire this mark-to-market change would produce what I described as “wild and capricious swings in our bottom line.”

The accuracy of that prediction can be suggested by our quarterly results during 2018. In the first and fourth quarters, we reported GAAP *losses* of \$1.1 billion and \$25.4 billion respectively. In the second and third quarters, we reported *profits* of \$12 billion and \$18.5 billion. In complete contrast to these gyrations, the many businesses that Berkshire owns delivered consistent and satisfactory operating earnings in *all* quarters. For the year, those earnings exceeded their 2016 high of \$17.6 billion by 41%.

Wide swings in our quarterly GAAP earnings will inevitably continue. That’s because our huge equity portfolio – valued at nearly \$173 billion at the end of 2018 – will often experience one-day price fluctuations of \$2 billion or more, all of which the new rule says must be dropped immediately to our bottom line. Indeed, in the fourth quarter, a period of high volatility in stock prices, we experienced several days with a “profit” or “loss” of more than \$4 billion.

Our advice? **Focus on operating earnings, paying little attention to gains or losses of any variety.** My saying that in no way diminishes the importance of our investments to Berkshire. **Over time, Charlie and I expect them to deliver substantial gains, albeit with highly irregular timing.**

* * * * *

Long-time readers of our annual reports will have spotted the different way in which I opened this letter. For nearly three decades, the initial paragraph featured the percentage change in Berkshire’s per-share book value. It’s now time to abandon that practice.

The fact is that the **annual change in Berkshire’s book value – which makes its farewell appearance on page 2 – is a metric that has lost the relevance it once had.** Three circumstances have made that so. First, Berkshire has gradually morphed from a company whose assets are concentrated in marketable stocks into one whose major value resides in operating businesses. Charlie and I expect that reshaping to continue in an irregular manner. Second, while our *equity holdings* are valued at market prices, accounting rules require our collection of *operating companies* to be included in book value at an amount far below their current value, a mismatch that has grown in recent years. Third, it is likely that – over time – **Berkshire will be a significant repurchaser of its shares, transactions that will take place at prices above book value but below our estimate of intrinsic value. The math of such purchases is simple: Each transaction makes per-share intrinsic value go up, while per-share book value goes down. That combination causes the book-value scorecard to become increasingly out of touch with economic reality.**

→ How and when buybacks create value.
(Book value < Buyback price < Intrinsic value)

In future tabulations of our financial results, we expect to focus on Berkshire's market price. Markets can be extremely capricious: Just look at the 54-year history laid out on page 2. **Over time, however, Berkshire's stock price will provide the best measure of business performance.**

Before moving on, I want to give you some good news – *really* good news – that is not reflected in our financial statements. It concerns the management changes we made in early 2018, when Ajit Jain was put in charge of all insurance activities and Greg Abel was given authority over all other operations. These moves were overdue. Berkshire is now far better managed than when I alone was supervising operations. Ajit and Greg have rare talents, and Berkshire blood flows through their veins.

Now let's take a look at what you own.

Focus on the Forest – Forget the Trees

Investors who evaluate Berkshire sometimes obsess on the details of our many and diverse businesses – our economic “trees,” so to speak. Analysis of that type can be mind-numbing, given that **we own a vast array of specimens, ranging from twigs to redwoods. A few of our trees are diseased and unlikely to be around a decade from now. Many others, though, are destined to grow in size and beauty.**

Fortunately, it's not necessary to evaluate each tree individually to make a rough estimate of Berkshire's intrinsic business value. That's because our forest contains five “groves” of major importance, each of which can be appraised, with reasonable accuracy, in its entirety. Four of those groves are differentiated clusters of businesses and financial assets that are easy to understand. The fifth – our huge and diverse insurance operation – delivers great value to Berkshire in a less obvious manner, one I will explain later in this letter.

World's Best Investment Checklist

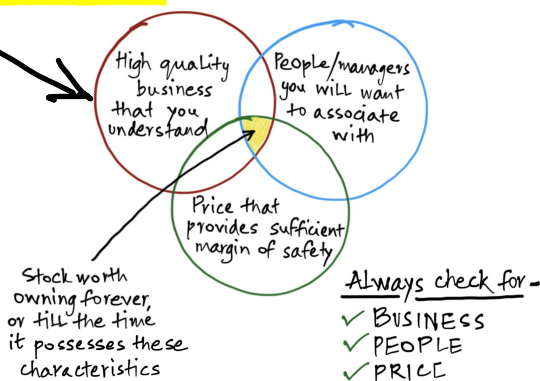
Before we look more closely at the first four groves, let me remind you of **our prime goal in the deployment of your capital: to buy ably-managed businesses, in whole or part, that possess favorable and durable economic characteristics. We also need to make these purchases at sensible prices.**

Sometimes we can buy control of companies that meet our tests. Far more often, we find the attributes we seek in publicly-traded businesses, in which we normally acquire a 5% to 10% interest. **Our two-pronged approach to huge-scale capital allocation is rare in corporate America and, at times, gives us an important advantage.**

In recent years, the sensible course for us to follow has been clear: **Many stocks have offered far more for our money than we could obtain by purchasing businesses in their entirety. That disparity led us to buy about \$43 billion of marketable equities last year, while selling only \$19 billion. Charlie and I believe the companies in which we invested offered excellent value, far exceeding that available in takeover transactions.**

Despite our recent additions to marketable equities, the most valuable grove in Berkshire's forest remains the many dozens of non-insurance businesses that Berkshire controls (usually with 100% ownership and never with less than 80%). Those subsidiaries earned \$16.8 billion last year. When we say “earned,” moreover, we are describing what remains after *all* income taxes, interest payments, managerial compensation (whether cash or stock-based), restructuring expenses, depreciation, amortization and home-office overhead.

That brand of earnings is a far cry from that frequently touted by Wall Street bankers and corporate CEOs. Too often, their presentations feature “adjusted EBITDA,” a measure that redefines “earnings” to exclude a variety of all-too-real costs.



View investing through a wide-angle lens, zooming out, taking a Long-term perspective, and striving for long, sustained upward trend in stocks instead of worrying about short-term volatility in their prices.

For example, managements sometimes assert that their company's stock-based compensation shouldn't be counted as an expense. (What else could it be – a gift from shareholders?) And restructuring expenses? Well, maybe last year's exact rearrangement won't recur. But restructurings of one sort or another are common in business – Berkshire has gone down that road dozens of times, and our shareholders have always borne the costs of doing so.

Haha!

Abraham Lincoln once posed the question: "If you call a dog's tail a leg, how many legs does it have?" and then answered his own query: "Four, because calling a tail a leg doesn't make it one." Abe would have felt lonely on Wall Street.

Charlie and I do contend that our acquisition-related amortization expenses of \$1.4 billion (detailed on page K-84) are not a true economic cost. We add back such amortization "costs" to GAAP earnings when we are evaluating both private businesses and marketable stocks.

*** Depreciation ≈ Maintenance Capex**

In contrast, Berkshire's \$8.4 billion depreciation charge understates our true economic cost. In fact, we need to spend more than this sum annually to simply remain competitive in our many operations. Beyond those "maintenance" capital expenditures, we spend large sums in pursuit of growth. Overall, Berkshire invested a record \$14.5 billion last year in plant, equipment and other fixed assets, with 89% of that spent in America.

Berkshire's runner-up grove by value is its collection of equities, typically involving a 5% to 10% ownership position in a very large company. As noted earlier, our equity investments were worth nearly \$173 billion at yearend, an amount far above their cost. If the portfolio had been sold at its yearend valuation, federal income tax of about \$14.7 billion would have been payable on the gain. In all likelihood, we will hold most of these stocks for a long time. Eventually, however, gains generate taxes at whatever rate prevails at the time of sale.

Our investees paid us dividends of \$3.8 billion last year, a sum that will increase in 2019. Far more important than the dividends, though, are the huge earnings that are annually retained by these companies. Consider, as an indicator, these figures that cover only our five largest holdings.

Company	Yearend Ownership	Berkshire's Share in \$ millions of Dividends(1)	Retained Earnings(2)
American Express	17.9%	\$ 237	\$ 997
Apple	5.4%	745	2,502
Bank of America	9.5%	551	2,096
Coca-Cola	9.4%	624	(21)
Wells Fargo	9.8%	809	1,263
Total		\$2,966	\$6,837

*** For companies that can earn high return on incremental retained earnings, you're better off not seeking dividends**

- (1) Based on current annual rate.
- (2) Based on 2018 earnings minus common and preferred dividends paid.

GAAP – which dictates the earnings we report – does not allow us to include the retained earnings of investees in our financial accounts. But those earnings are of enormous value to us: Over the years, earnings retained by our investees (viewed as a group) have eventually delivered capital gains to Berkshire that totaled more than one dollar for each dollar these companies reinvested for us.

All of our major holdings enjoy excellent economics, and most use a portion of their retained earnings to repurchase their shares. We very much like that: If Charlie and I think an investee's stock is underpriced, we rejoice when management employs some of its earnings to increase Berkshire's ownership percentage.

Wow!

Here's one example drawn from the table above: Berkshire's holdings of American Express have remained unchanged over the past eight years. Meanwhile, our ownership increased from 12.6% to 17.9% because of repurchases made by the company. Last year, Berkshire's portion of the \$6.9 billion earned by American Express was \$1.2 billion, about 96% of the \$1.3 billion we paid for our stake in the company. When earnings increase and shares outstanding decrease, owners – over time – usually do well. (Buffett bought Amex in 1964)

A third category of Berkshire's business ownership is a quartet of companies in which we share control with other parties. Our portion of the after-tax operating earnings of these businesses – 26.7% of Kraft Heinz, 50% of Berkadia and Electric Transmission Texas, and 38.6% of Pilot Flying J – totaled about \$1.3 billion in 2018.

In our fourth grove, Berkshire held \$112 billion at yearend in U.S. Treasury bills and other cash equivalents, and another \$20 billion in miscellaneous fixed-income instruments. We consider a portion of that stash to be untouchable, having pledged to always hold at least \$20 billion in cash equivalents to guard against external calamities. We have also promised to avoid any activities that could threaten our maintaining that buffer. (Margin of safety)

Berkshire will forever remain a financial fortress. In managing, I will make expensive mistakes of commission and will also miss many opportunities, some of which should have been obvious to me. At times, our stock will tumble as investors flee from equities. But I will never risk getting caught short of cash.

In the years ahead, we hope to move much of our excess liquidity into businesses that Berkshire will permanently own. The immediate prospects for that, however, are not good: Prices are sky-high for businesses possessing decent long-term prospects. (In India too!)

That disappointing reality means that 2019 will likely see us again expanding our holdings of marketable equities. We continue, nevertheless, to hope for an elephant-sized acquisition. Even at our ages of 88 and 95 – I'm the young one – that prospect is what causes my heart and Charlie's to beat faster. (Just writing about the possibility of a huge purchase has caused my pulse rate to soar.) → Wish more capital allocator CEOs thought/behaved like this

My expectation of more stock purchases is *not* a market call. Charlie and I have no idea as to how stocks will behave next week or next year. Predictions of that sort have never been a part of our activities. Our thinking, rather, is focused on calculating whether a portion of an attractive business is worth more than its market price.

(No one has any idea about the future, so please don't make or take any predictions)*****

I believe Berkshire's intrinsic value can be approximated by summing the values of our four asset-laden groves and then subtracting an appropriate amount for taxes eventually payable on the sale of marketable securities.

You may ask whether an allowance should not also be made for the major tax costs Berkshire would incur if we were to sell certain of our wholly-owned businesses. Forget that thought: It would be foolish for us to sell any of our wonderful companies even if no tax would be payable on its sale. Truly good businesses are exceptionally hard to find. Selling any you are lucky enough to own makes no sense at all. → Never sell a high quality business

The interest cost on *all* of our debt has been deducted as an expense in calculating the earnings at Berkshire's non-insurance businesses. Beyond that, much of our ownership of the first four groves is financed by funds generated from Berkshire's fifth grove – a collection of exceptional insurance companies. We call those funds "float," a source of financing that we expect to be cost-free – or maybe even better than that – over time. We will explain the characteristics of float later in this letter.

Finally, a point of key and lasting importance: Berkshire's value is maximized by our having assembled the five groves into a single entity. This arrangement allows us to seamlessly and objectively allocate major amounts of capital, eliminate enterprise risk, avoid insularity, fund assets at exceptionally low cost, occasionally take advantage of tax efficiencies, and minimize overhead.

At Berkshire, the whole is greater – considerably greater – than the sum of the parts.

Repurchases and Reporting

Earlier I mentioned that Berkshire will from time to time be repurchasing its own stock. Assuming that we buy at a discount to Berkshire's intrinsic value – which certainly will be our intention – repurchases will benefit both those shareholders leaving the company and those who stay.

True, the upside from repurchases is very slight for those who are leaving. That's because careful buying by us will minimize any impact on Berkshire's stock price. Nevertheless, there is *some* benefit to sellers in having an extra buyer in the market.

*** Lesson on honest communication for managers**

For continuing shareholders, the advantage is obvious: If the market prices a departing partner's interest at, say, 90¢ on the dollar, continuing shareholders reap an increase in per-share intrinsic value with every repurchase by the company. Obviously, repurchases should be price-sensitive: **Blindly buying an overpriced stock is value-destructive, a fact lost on many promotional or ever-optimistic CEOs.**

When a company says that it contemplates repurchases, it's vital that all shareholder-partners be given the information they need to make an intelligent estimate of value. Providing that information is what Charlie and I try to do in this report. We do not want a partner to sell shares back to the company because he or she has been misled or inadequately informed.

Some sellers, however, may disagree with our calculation of value and others may have found investments that they consider more attractive than Berkshire shares. Some of that second group will be right: There are unquestionably many stocks that will deliver far greater gains than ours.

In addition, **certain shareholders will simply decide it's time for them or their families to become net consumers rather than continuing to build capital. Charlie and I have no current interest in joining that group. Perhaps we will become big spenders in our old age.**

Ha ha! These guys are young!

For 54 years our managerial decisions at Berkshire have been made from the viewpoint of the shareholders who are staying, not those who are leaving. Consequently, **Charlie and I have never focused on current-quarter results.**

Berkshire, in fact, may be the only company in the Fortune 500 that does not prepare monthly earnings reports or balance sheets. I, of course, regularly view the monthly financial reports of most subsidiaries. But Charlie and I learn of Berkshire's overall earnings and financial position only on a quarterly basis.

*** Focus on the forest, forget the trees**

Furthermore, Berkshire has no company-wide budget (though many of our subsidiaries find one useful). Our lack of such an instrument means that the parent company has *never* had a quarterly "number" to hit. Shunning the use of this bogey sends an important message to our many managers, reinforcing the culture we prize.

Over the years, Charlie and I have seen all sorts of bad corporate behavior, both accounting and operational, induced by the desire of management to meet Wall Street expectations. What starts as an "innocent" fudge in order to not disappoint "the Street" – say, trade-loading at quarter-end, turning a blind eye to rising insurance losses, or drawing down a "cookie-jar" reserve – can become the first step toward full-fledged fraud. Playing with the numbers "just this once" may well be the CEO's intent; it's seldom the end result. And if it's okay for the boss to cheat a little, it's easy for subordinates to rationalize similar behavior.

(Slow Contrast Effect)

At Berkshire, our audience is neither analysts nor commentators: Charlie and I are working for our shareholder-partners. The numbers that flow up to us will be the ones we send on to you.

As happened in Satyam's case, – read Ramalinga Raju's letter →

The gap in the Balance Sheet has arisen purely on account of inflated profits over a period of last several years (limited only to Satyam standalone, books of subsidiaries reflecting true performance). What started as a marginal gap between actual operating profit and the one reflected in the books of accounts continued to grow over the years. It has attained unmanageable proportions as the size of company operations grew significantly (annualized revenue run rate of Rs. 11,276 crore in the September quarter, 2008 and official reserves of Rs. 8,392 crore). The differential in the real profits and the one reflected in the books was further accentuated by the fact that the company had to carry additional resources and assets to justify higher level of operations – thereby significantly increasing the costs.

Every attempt made to eliminate the gap failed. As the promoters held a small percentage of equity, the concern was that poor performance would result in a take-over, thereby exposing the gap. **It was like riding a tiger, not knowing how to get off without being eaten.**

Non-Insurance Operations – From Lollipops to Locomotives

Let's now look further at Berkshire's most valuable grove – our collection of non-insurance businesses – keeping in mind that we do not wish to unnecessarily hand our competitors information that might be useful to them. Additional details about individual operations can be found on pages K-5 – K-22 and pages K-40 – K-51.

Viewed as a group, these businesses earned pre-tax income in 2018 of \$20.8 billion, a 24% increase over 2017. Acquisitions we made in 2018 delivered only a trivial amount of that gain.

I will stick with pre-tax figures in this discussion. But our after-tax gain in 2018 from these businesses was *far* greater – 47% – thanks in large part to the cut in the corporate tax rate that became effective at the beginning of that year. Let's look at why the impact was so dramatic.

Begin with an economic reality: Like it or not, the U.S. Government “owns” an interest in Berkshire's earnings of a size determined by Congress. In effect, our country's Treasury Department holds a special class of our stock – call this holding the AA shares – that receives large “dividends” (that is, tax payments) from Berkshire. In 2017, as in many years before, the corporate tax rate was 35%, which meant that the Treasury was doing very well with its AA shares. Indeed, the Treasury's “stock,” which was paying nothing when we took over in 1965, had evolved into a holding that delivered billions of dollars annually to the federal government.

Last year, however, 40% of the government's “ownership” (14/35^{ths}) was returned to Berkshire – free of charge – when the corporate tax rate was reduced to 21%. Consequently, our “A” and “B” shareholders received a major boost in the earnings attributable to *their* shares.

This happening materially increased the intrinsic value of the Berkshire shares you and I own. The same dynamic, moreover, enhanced the intrinsic value of almost all of the stocks Berkshire holds.

Those are the headlines. But there are other factors to consider that tempered our gain. For example, the tax benefits garnered by our large utility operation get passed along to its customers. Meanwhile, the tax rate applicable to the substantial dividends we receive from domestic corporations is little changed at about 13%. (This lower rate has long been logical because our investees have already paid tax on the earnings that they pay to us.) Overall, however, the new law made our businesses and the stocks we own *considerably* more valuable.

Which suggests that we return to the performance of our non-insurance businesses. Our two towering redwoods in this grove are BNSF and Berkshire Hathaway Energy (90.9% owned). Combined, they earned \$9.3 billion before tax last year, up 6% from 2017. You can read more about these businesses on pages K-5 – K-10 and pages K-40 – K-45.

Our next five non-insurance subsidiaries, as ranked by earnings (but presented here alphabetically), Clayton Homes, International Metalworking, Lubrizol, Marmon and Precision Castparts, had aggregate pre-tax income in 2018 of \$6.4 billion, up from the \$5.5 billion these companies earned in 2017.

The next five, similarly ranked and listed (Forest River, Johns Manville, MiTek, Shaw and TTI) earned \$2.4 billion pre-tax last year, up from \$2.1 billion in 2017.

The remaining non-insurance businesses that Berkshire owns – and there are many – had pre-tax income of \$3.6 billion in 2018 vs. \$3.3 billion in 2017.

Insurance, “Float,” and the Funding of Berkshire

Our property/casualty (“P/C”) insurance business – our fifth grove – has been the engine propelling Berkshire’s growth since 1967, the year we acquired National Indemnity and its sister company, National Fire & Marine, for \$8.6 million. Today, National Indemnity is the largest property/casualty company in the world as measured by net worth.

One reason we were attracted to the P/C business was the industry’s business model: P/C insurers receive premiums upfront and pay claims later. In extreme cases, such as claims arising from exposure to asbestos, or severe workplace accidents, payments can stretch over many decades.

This collect-now, pay-later model leaves P/C companies holding large sums – money we call “float” – that will eventually go to others. Meanwhile, insurers get to invest this float for their own benefit. Though individual policies and claims come and go, the amount of float an insurer holds usually remains fairly stable in relation to premium volume. Consequently, as our business grows, so does our float. And *how* it has grown, as the following table shows:

Year	Float (in millions)*
1970	\$ 39
1980	237
1990	1,632
2000	27,871
2010	65,832
2018	122,732

* One key factor that helped in the success of Buffett (Google - NBER Buffett Alpha)

18.3% CAGR

* Includes float arising from life, annuity and health insurance businesses.

We may in time experience a decline in float. If so, the decline will be *very* gradual – at the outside no more than 3% in any year. The nature of our insurance contracts is such that we can *never* be subject to immediate or near-term demands for sums that are of significance to our cash resources. That structure is by design and is a key component in the unequalled financial strength of our insurance companies. That strength will *never* be compromised.

If our premiums exceed the total of our expenses and eventual losses, our insurance operation registers an underwriting profit that adds to the investment income the float produces. When such a profit is earned, we enjoy the use of free money – and, better yet, get *paid* for holding it.

Unfortunately, the wish of all insurers to achieve this happy result creates intense competition, so vigorous indeed that it sometimes causes the P/C industry as a whole to operate at a significant underwriting *loss*. That loss, in effect, is what the industry pays to hold its float. Competitive dynamics almost guarantee that the insurance industry, despite the float income all its companies enjoy, will continue its dismal record of earning subnormal returns on tangible net worth as compared to other American businesses.

Nevertheless, I like our own prospects. Berkshire’s unrivaled financial strength allows us the flexibility in investing our float than that generally available to P/C companies. The many alternatives available to us are always an advantage and occasionally offer major opportunities. When other insurers are constrained, our choices expand.

Moreover, our P/C companies have an excellent underwriting record. Berkshire has now operated at an underwriting profit for 15 of the past 16 years, the exception being 2017, when our pre-tax loss was \$3.2 billion. For the entire 16-year span, our pre-tax gain totaled \$27 billion, of which \$2 billion was recorded in 2018.

That record is no accident: Disciplined risk evaluation is the daily focus of our insurance managers, who know that the benefits of float can be drowned by poor underwriting results. All insurers give that message lip service. At Berkshire it is a religion, Old Testament style.

In most cases, the funding of a business comes from two sources – debt and equity. At Berkshire, we have two additional arrows in the quiver to talk about, but let’s first address the conventional components.

We use debt sparingly. Many managers, it should be noted, will disagree with this policy, arguing that significant debt juices the returns for equity owners. And these more venturesome CEOs will be right *most* of the time.

At rare and unpredictable intervals, however, credit vanishes and debt becomes financially fatal. A Russian-roulette equation – [usually win, occasionally die] – may make financial sense for someone who gets a piece of a company’s upside but does not share in its downside. But that strategy would be madness for Berkshire. Rational people don’t risk what they have and need for what they don’t have and don’t need.

→ Imp. Lesson worth practicing and teaching your kids

Most of the debt you see on our consolidated balance sheet – see page K-65 – resides at our railroad and energy subsidiaries, both of them asset-heavy companies. During recessions, the cash generation of these businesses remains bountiful. The debt they use is both appropriate for their operations and *not* guaranteed by Berkshire.

Our level of equity capital is a different story: Berkshire’s \$349 billion is unmatched in corporate America. By retaining all earnings for a very long time, and allowing compound interest to work its magic, we have amassed funds that have enabled us to purchase and develop the valuable groves earlier described. Had we instead followed a 100% payout policy, we would still be working with the \$22 million with which we began fiscal 1965.

Beyond using debt and equity, Berkshire has benefitted in a major way from two less-common sources of corporate funding. The larger is the float I have described. So far, those funds, though they are recorded as a huge net liability on our balance sheet, have been of more utility to us than an equivalent amount of equity. That’s because they have usually been accompanied by underwriting earnings. In effect, we have been paid in most years for holding and using other people’s money.

As I have often done before, I will emphasize that this happy outcome is far from a sure thing: Mistakes in assessing insurance risks can be huge and can take many years to surface. (Think asbestos.) A major catastrophe that will dwarf hurricanes Katrina and Michael will occur – perhaps tomorrow, perhaps many decades from now. “The Big One” may come from a traditional source, such as a hurricane or earthquake, or it may be a total surprise involving, say, a cyber attack having disastrous consequences beyond anything insurers now contemplate. When such a mega-catastrophe strikes, we will get our share of the losses and they will be big – very big. Unlike many other insurers, however, we will be looking to add business the next day.

The final funding source – which again Berkshire possesses to an unusual degree – is deferred income taxes. These are liabilities that we will eventually pay but that are meanwhile interest-free.

As I indicated earlier, about \$14.7 billion of our \$50.5 billion of deferred taxes arises from the unrealized gains in our equity holdings. These liabilities are accrued in our financial statements at the current 21% corporate tax rate but will be paid at the rates prevailing when our investments are sold. Between now and then, we in effect have an interest-free “loan” that allows us to have more money working for us in equities than would otherwise be the case.

Russian Roulette



← Probability of success may be high, but consequence of failure is huge!



↑ Most capital allocators must understand this well

A further \$28.3 billion of deferred tax results from our being able to accelerate the depreciation of assets such as plant and equipment in calculating the tax we must currently pay. The front-ended savings in taxes that we record gradually reverse in future years. We regularly purchase additional assets, however. As long as the present tax law prevails, this source of funding should trend upward.

Over time, Berkshire's funding base – that's the right-hand side of our balance sheet – should grow, primarily through the earnings we retain. Our job is to put the money retained to good use on the left-hand side, by adding attractive assets.

GEICO and Tony Nicely

That title says it all: The company and the man are inseparable.

Tony joined GEICO in 1961 at the age of 18; I met him in the mid-1970s. At that time, GEICO, after a four-decade record of both rapid growth and outstanding underwriting results, suddenly found itself near bankruptcy. A recently-installed management had grossly underestimated GEICO's loss costs and consequently underpriced its product. It would take many months until those loss-generating policies on GEICO's books – there were no less than 2.3 million of them – would expire and could then be repriced. The company's net worth in the meantime was rapidly approaching zero.

In 1976, Jack Byrne was brought in as CEO to rescue GEICO. Soon after his arrival, I met him, concluded that he was the perfect man for the job, and began to aggressively buy GEICO shares. Within a few months, Berkshire bought about $\frac{1}{3}$ of the company, a portion that later grew to roughly $\frac{1}{2}$ without our spending a dime. That stunning accretion occurred because GEICO, after recovering its health, consistently repurchased its shares. All told, this half-interest in GEICO cost Berkshire \$47 million, about what you might pay today for a trophy apartment in New York.

Let's now fast-forward 17 years to 1993, when Tony Nicely was promoted to CEO. At that point, GEICO's reputation and profitability had been restored – but not its growth. Indeed, at yearend 1992 the company had only 1.9 million auto policies on its books, far less than its pre-crisis high. In sales volume among U.S. auto insurers, GEICO then ranked an undistinguished seventh.

Late in 1995, after Tony had re-energized GEICO, Berkshire made an offer to buy the remaining 50% of the company for \$2.3 billion, about 50 times what we had paid for the first half (and people say I never pay up!). Our offer was successful and brought Berkshire a wonderful, but underdeveloped, company and an equally wonderful CEO, who would move GEICO forward beyond my dreams.

GEICO is now America's Number Two auto insurer, with sales 1,200% greater than it recorded in 1995. Underwriting profits have totaled \$15.5 billion (pre-tax) since our purchase, and float available for investment has grown from \$2.5 billion to \$22.1 billion.

By my estimate, Tony's management of GEICO has increased Berkshire's intrinsic value by more than \$50 billion. On top of that, he is a model for everything a manager should be, helping his 40,000 associates to identify and polish abilities they didn't realize they possessed.

Last year, Tony decided to retire as CEO, and on June 30th he turned that position over to Bill Roberts, his long-time partner. I've known and watched Bill operate for several decades, and once again Tony made the right move. Tony remains Chairman and will be helpful to GEICO for the rest of his life. He's incapable of doing less.

All Berkshire shareholders owe Tony their thanks. I head the list.

Investments

Below we list our fifteen common stock investments that at yearend had the largest market value. We exclude our Kraft Heinz holding – 325,442,152 shares – because Berkshire is part of a control group and therefore must account for this investment on the “equity” method. On its balance sheet, Berkshire carries its Kraft Heinz holding at a GAAP figure of \$13.8 billion, an amount reduced by our share of the large write-off of intangible assets taken by Kraft Heinz in 2018. At yearend, our Kraft Heinz holding had a market value of \$14 billion and a cost basis of \$9.8 billion.

<u>Shares*</u>	<u>Company</u>	<u>Percentage of Company Owned</u>	12/31/18	
			<u>Cost**</u>	<u>Market</u>
			(in millions)	
151,610,700	American Express Company	17.9	\$ 1,287	\$ 14,452
255,300,329	Apple Inc.	5.4	36,044	40,271
918,919,000	Bank of America Corp.	9.5	11,650	22,642
84,488,751	The Bank of New York Mellon Corp.	8.8	3,860	3,977
6,789,054	Charter Communications, Inc.	3.0	1,210	1,935
400,000,000	The Coca-Cola Company	9.4	1,299	18,940
65,535,000	Delta Air Lines, Inc.	9.6	2,860	3,270
18,784,698	The Goldman Sachs Group, Inc.	4.9	2,380	3,138
50,661,394	JPMorgan Chase & Co.	1.5	5,605	4,946
24,669,778	Moody’s Corporation	12.9	248	3,455
47,890,899	Southwest Airlines Co.	8.7	2,005	2,226
21,938,642	United Continental Holdings Inc.	8.1	1,195	1,837
146,346,999	U.S. Bancorp	9.1	5,548	6,688
43,387,980	USG Corporation	31.0	836	1,851
449,349,102	Wells Fargo & Company	9.8	10,639	20,706
	Others		16,201	22,423
	Total Common Stocks Carried at Market		<u>\$ 102,867</u>	<u>\$ 172,757</u>

* Excludes shares held by pension funds of Berkshire subsidiaries.

** This is our actual purchase price and also our tax basis.

Charlie and I do *not* view the \$172.8 billion detailed above as a collection of ticker symbols – a financial dalliance to be terminated because of downgrades by “the Street,” expected Federal Reserve actions, possible political developments, forecasts by economists or whatever else might be the subject *du jour*.

What we see in our holdings, rather, is an assembly of companies that we partly own and that, on a weighted basis, are earning about 20% on the net tangible equity capital required to run their businesses. These companies, also, earn their profits without employing excessive levels of debt.



“Shares are not mere pieces of paper. They represent part ownership of a business. So, when contemplating an investment, think like a prospective owner.”
~ Warren Buffett

→ 20% ROE + Low Debt = Great combination

Great business ≠ Great investment (when you overpay).
But, Long term, business performance holds greater
relevance than original price paid

Returns of that order by large, established and understandable businesses are remarkable under any circumstances. They are truly mind-blowing when compared against the return that many investors have accepted on bonds over the last decade – 3% or less on 30-year U.S. Treasury bonds, for example.

On occasion, a ridiculously-high purchase price for a given stock will cause a splendid business to become a poor investment – if not permanently, at least for a painfully long period. Over time, however, investment performance converges with business performance. And, as I will next spell out, the record of American business has been extraordinary.

↳ Took me long to appreciate this. But, since then, it's worked out fairly well

The American Tailwind
On March 11th, it will be 77 years since I first invested in an American business. The year was 1942, I was 11, and I went all in, investing \$114.75 I had begun accumulating at age six. What I bought was three shares of Cities Service preferred stock. I had become a capitalist, and it felt good. → Start compounding early

Let's now travel back through the two 77-year periods that preceded my purchase. That leaves us starting in 1788, a year prior to George Washington's installation as our first president. Could anyone then have imagined what their new country would accomplish in only three 77-year lifetimes?

During the two 77-year periods prior to 1942, the United States had grown from four million people – about 1/2 of 1% of the world's population – into the most powerful country on earth. In that spring of 1942, though, it faced a crisis: The U.S. and its allies were suffering heavy losses in a war that we had entered only three months earlier. Bad news arrived daily.

Despite the alarming headlines, almost all Americans believed on that March 11th that the war would be won. Nor was their optimism limited to that victory. Leaving aside congenital pessimists, Americans believed that their children and generations beyond would live far better lives than they themselves had led.

The nation's citizens understood, of course, that the road ahead would not be a smooth ride. It never had been. Early in its history our country was tested by a Civil War that killed 4% of all American males and led President Lincoln to openly ponder whether "a nation so conceived and so dedicated could long endure." In the 1930s, America suffered through the Great Depression, a punishing period of massive unemployment.

Nevertheless, in 1942, when I made my purchase, the nation expected post-war growth, a belief that proved to be well-founded. In fact, the nation's achievements can best be described as breathtaking.

(wish there existed such a fund in India)
Let's put numbers to that claim: If my \$114.75 had been invested in a no-fee S&P 500 index fund, and all dividends had been reinvested, my stake would have grown to be worth (pre-taxes) \$606,811 on January 31, 2019 (the latest data available before the printing of this letter). That is a gain of 5,288 for 1. Meanwhile, a \$1 million investment by a tax-free institution of that time – say, a pension fund or college endowment – would have grown to about \$5.3 billion.

Let me add one additional calculation that I believe will shock you: If that hypothetical institution had paid only 1% of assets annually to various "helpers," such as investment managers and consultants, its gain would have been cut in half, to \$2.65 billion. That's what happens over 77 years when the 11.8% annual return actually achieved by the S&P 500 is recalculated at a 10.8% rate.

↑
A nice story on compounding over long periods of time, and also what happens when costs – however small – also compound

Those who regularly preach doom because of government budget deficits (as I regularly did myself for many years) might note that our country's national debt has increased roughly 400-fold during the last of my 77-year periods. That's 40,000%! Suppose you had foreseen this increase and panicked at the prospect of runaway deficits and a worthless currency. To "protect" yourself, you might have eschewed stocks and opted instead to buy 3 1/4 ounces of gold with your \$114.75.

And what would that supposed protection have delivered? You would now have an asset worth about \$4,200, less than 1% of what would have been realized from a simple unmanaged investment in American business. The magical metal was no match for the American mettle. → For the long term, buy stocks, not gold

Our country's almost unbelievable prosperity has been gained in a bipartisan manner. Since 1942, we have had seven Republican presidents and seven Democrats. In the years they served, the country contended at various times with a long period of viral inflation, a 21% prime rate, several controversial and costly wars, the resignation of a president, a pervasive collapse in home values, a paralyzing financial panic and a host of other problems. All engendered scary headlines; all are now history.

Christopher Wren, architect of St. Paul's Cathedral, lies buried within that London church. Near his tomb are posted these words of description (translated from Latin): "If you would seek my monument, look around you." Those skeptical of America's economic playbook should heed his message.

In 1788 – to go back to our starting point – there really wasn't much here *except* for a small band of ambitious people and an embryonic governing framework aimed at turning their dreams into reality. Today, the Federal Reserve estimates our household wealth at \$108 trillion, an amount almost impossible to comprehend.

Remember, earlier in this letter, how I described retained earnings as having been the key to Berkshire's prosperity? So it has been with America. In the nation's accounting, the comparable item is labeled "savings." And save we have. If our forefathers had instead consumed all they produced, there would have been no investment, no productivity gains and no leap in living standards.

Charlie and I happily acknowledge that much of Berkshire's success has simply been a product of what I think should be called *The American Tailwind*. It is beyond arrogance for American businesses or individuals to boast that they have "done it alone." The tidy rows of simple white crosses at Normandy should shame those who make such claims.

(yes, India too!)

There are also many other countries around the world that have bright futures. About that, we should rejoice: Americans will be both more prosperous and safer if *all* nations thrive. At Berkshire, we hope to invest significant sums across borders.

Over the next 77 years, however, the major source of our gains will almost certainly be provided by The American Tailwind. We are lucky – gloriously lucky – to have that force at our back.

The Annual Meeting

(8:15 PM IST)

Berkshire's 2019 annual meeting will take place on Saturday, May 4th. If you are thinking about attending – and Charlie and I hope you come – check out the details on pages A-2 – A-3. They describe the same schedule we've followed for some years.

If you can't join us in Omaha, attend via Yahoo's webcast. Andy Serwer and his Yahoo associates do an outstanding job, both in covering the entire meeting and interviewing many Berkshire managers, celebrities, financial experts and shareholders from the U.S. and abroad. The world's knowledge of what goes on in Omaha the first Saturday of every May has grown dramatically since Yahoo came on board. Its coverage begins at 8:45 a.m. CDT and provides Mandarin translation.

For 54 years, Charlie and I have loved our jobs. Daily, we do what we find interesting, working with people we like and trust. And now our new management structure has made our lives even more enjoyable.

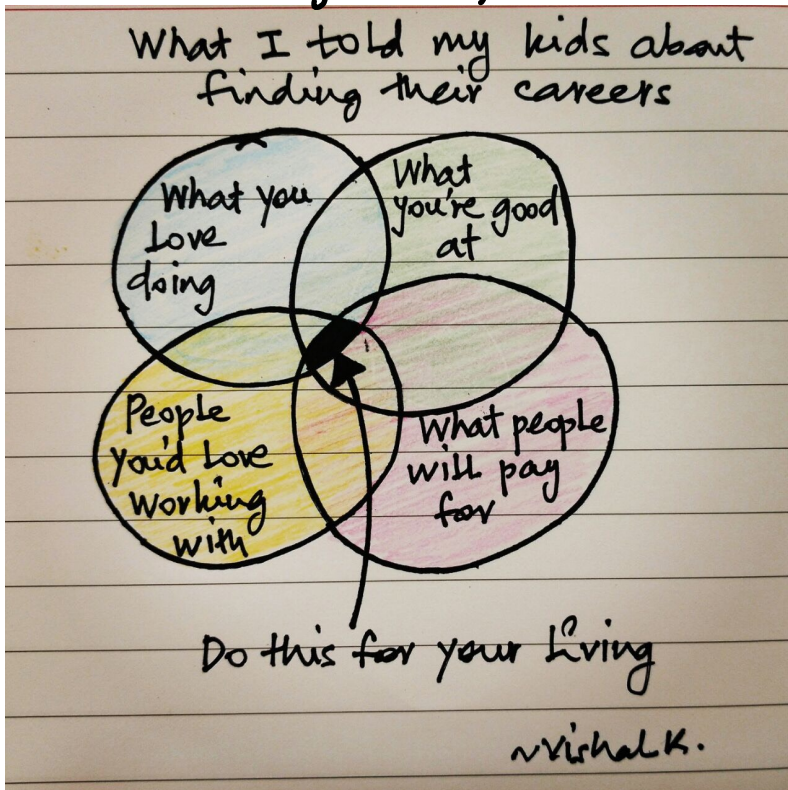
With the whole ensemble – that is, with Ajit and Greg running operations, a great collection of businesses, a Niagara of cash-generation, a cadre of talented managers and a rock-solid culture – your company is in good shape for whatever the future brings.

→ Being cheerful is one of the secrets to healthy and long life

February 23, 2019

Warren E. Buffett
Chairman of the Board

Buffett & Munger may like this...



————— X —————

[Analysis by - Vishal K - safalniveshak.com - 26/2/19]
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