

Table of Contents

Building blocks	4
What should be focus of long term investor	4
Surest means of profit is value investing	4
Think long term to evaluate performance.....	4
Beating index is very tough.....	5
True conservatism.....	5
Magic of Compounding.....	6
Price is everything aka Margin of Safety.....	6
Cigar butt as a group works out to be a good investment	6
Evaluate money manager even if it's you.....	7
Public opinion is not a substitute for though.....	7
Investing edge	7
Role of luck in Investing	7
Types of Investment.....	8
What is a work-out Investment ?.....	8
What are Generals ?	8
Security's prices movement.....	9
No movement is best for long term investors	9
Dividend and impact on price of securities	9

Illiquidity and prices 9

Playing volatility is a loser’s game..... 10

Past price behaviour is of no relevance 10

In short term demand and supply drive prices, In long term earnings power 10

Asset Allocation..... 11

 Asymmetric allocation 11

 Use mathematical expectation and it’s wideness to allocate 11

Qualities to look for in business..... 12

 Monopoly, recession proof..... 12

What works in Investing 13

 Buy the right Company 13

 Buy the right Price..... 13

Moat building activities..... 14

 Expenditure on sales and promotion..... 14

When to Sell..... 15

 When a security reaches Fair Value..... 15

 Sell when valuations catch up..... 15

Use of Leverage..... 16

 Utilise leverage in portfolio..... 16

Valuations 17

 What is not value 17

 Book value a better measure than next year PE..... 17

 Buy out of favour stock at bargain price to a private owner 17

What drives value – assets, Earnings power and industry conditions..... 17

Selling below Value to a Private owner 18

Management is key to investing 19

 Management is important in spite of good numbers..... 19

How a business turnarounds 20

 Reduce Inventory 20

 Free up Capital, reduce working capital and capex 20

 Cut overhead..... 20

 Closed inappropriate franchise..... 20

 Improve Earnings power 21

Diversification 22

 Bet hard when things are in your favour 22

 Consequences of wide diversification 22

Why Typical money managers fail 23

What businesses to avoid 24

 Business dependent on trickle of ideas 24

 Business with a human issue 24

Book Recommendations 25

Building blocks

What should be focus of long term investor

Primary attention is given at all times to the detection of substantially undervalued securities.

1957, Letter

Surest means to earn profit is value investing

results. However, I believe that a program of investing in such undervalued well protected securities offers the surest means of long term profits in securities.

1958, Letter

Think long term to evaluate performance

begin to think in terms of short-term performance which can be most misleading. My own thinking is much more geared to five year performance, preferably with tests of relative results in both strong and weak markets.

1962, Letter

Our job is to pile up yearly advantages over the performance of the Dow without worrying too much about whether the absolute results in a given year are a plus or a minus. I would consider a year in which we were down 15% and the Dow declined 25% to be much superior to a year when both the partnership and the Dow advanced 20%.

1964, Letter

Beating index is very tough

companies where we had investments, would be no better, if as good. I present this data to indicate the Dow as an investment competitor is no pushover, and the great bulk of investment funds in the country are going to have difficulty in bettering, or perhaps even matching, its performance.

1962, Letter

Past letters have stressed our belief that the Dow is no pushover as a yardstick for investment performance. To the extent that funds are invested in common stocks, whether the manner of investment be through investment companies, investment counselors, bank trust departments, or do-it-yourself, our belief is that the overwhelming majority will achieve results roughly comparable to the Dow. Our opinion is that the deviations from the Dow

1963, Letter

particular year, if we can maintain a satisfactory edge on the Dow over an extended period of time, our long term results will be satisfactory -- financially as well as philosophically.

1964, Letter

True conservatism

True conservatism is only possible through knowledge and reason.

1963, Letter

To behave unconventionally within this framework is extremely difficult.

1964, Letter

("Price is what you pay. value is what you get").

1968, Letter

Magic of Compounding

The following table indicates the compounded value of \$100,000 at 5%, 10% and 15% for 10, 20 and 30 years. It is always startling to see how relatively small differences in rates add up to very significant sums over a period of years. That is why, even though we are shooting for more, we feel that a few percentage points advantage over the Dow is a very worthwhile achievement. It can mean a lot of dollars over a decade or two.

	5%	10%	15%
10 Years	\$162,889	\$259,374	\$404,553
20 Years	\$265,328	\$672,748	\$1,636,640
30 Years	\$432,191	\$1,744,930	\$6,621,140

1964, Letter

Price is everything aka Margin of Safety

of a hat to get extremely good percentage gains. This is the cornerstone of our investment philosophy: “Never count on making a good sale. Have the purchase price be so attractive that even a mediocre sale gives good results. The better sales will be the frosting on the cake.”

1964, Letter

Cigar butt as a group works out to be a good investment

The qualitative situation was on the negative side (a fairly tough industry and unimpressive management), but the figures were extremely attractive. Experience shows you can buy 100 situations like this and have perhaps 70 or 80 work out to reasonable profits in one to three years. Just why any particular one should do so is hard to

1964, Letter

Evaluate money manager even if it's you

Massachusetts Investors Trust or Lehman Corporation, it is of enormous dollars-and-cents importance to evaluate objectively the accomplishments of the fellow who is actually handling your money - even if it's you.

1964, Letter

Public opinion is not a substitute for thought

A public opinion poll is no substitute for thought.

1964, Letter

Investing edge

you consciously realize you are making the calculations or not. I believe the investor operates at a distinct advantage when he is aware of what path his thought process is following.

1965 Letter

Role of luck in Investing

All three of the 1956 partnerships showed a gain during the year amounting to about 6.2%, 7.8% and 25% on yearend 1956 net worth. Naturally a question is created as to the vastly superior performance of the last partnership, particularly in the mind of the partners of the first two. This performance emphasizes the importance of luck in the short run, particularly in regard to when funds are received.

1957, Letter

Types of Investment

What is a work-out Investment?

A work-out is an investment which is dependent on a specific corporate

action for its profit rather than a general advance in the price of the stock as in the case of undervalued situations. Work-outs come about through: sales, mergers, liquidations, tenders, etc. In each case, the risk is that something will upset the applectart and cause the abandonment of the planned action, not that the economic picture will deteriorate and stocks decline generally.

1957, Letter

Our second category consists of "work-outs." These are securities whose financial results depend on corporate action rather than supply and demand factors created by buyers and sellers of securities. In other words, they are securities with a timetable where we can predict, within reasonable error limits, when we will get how much and what might upset the applectart. Corporate events such as mergers, liquidations, reorganizations, spin-offs, etc., lead to work-outs. An important source in recent years has been sell-outs by oil producers to major integrated oil companies.

1963, Letter

What are Generals?

The first section consists of generally undervalued securities (hereinafter called "generals") where we have nothing to say about corporate policies and no timetable as to when the undervaluation may correct itself. Over the years, this has been our largest category of investment, and more money has been made here than in either of the other categories. We usually have fairly large positions (5% to 10% of our total assets) in each of five or six generals, with smaller positions in another ten or fifteen.

1963, Letter

Security's prices movement

No movement is best for long term investors

Obviously during any acquisition

period, our primary interest is to have the stock do nothing or decline rather than advance. Therefore, at any given time, a fair proportion of our portfolio may be in the sterile stage. This policy, while requiring patience, should maximize long term profits.

1957, Letter

Dividend and impact on price of securities

This stock was the Commonwealth Trust Co. of Union City, New Jersey. At the time we started to purchase the stock, it had an intrinsic value \$125 per share computed on a conservative basis. However, for good reasons, it

paid no cash dividend at all despite earnings of about \$10 per share which was largely responsible for a depressed price of about \$50 per share.!

1958, Letter

Illiquidity and prices

Commonwealth only had about 300 stockholders and probably averaged two trades or so per month, so you can understand why I say that the activity of the stock market generally had very little effect on the price movement of some of our holdings.

Very small buying orders can create price changes of this magnitude in an inactive stock.

1958, Letter

Playing volatility is a loser's game

term price behavior characteristics differ substantially in various types of markets. We consider attempting to gauge stock market fluctuations to be a very poor business on a long-term basis and are not going to be in it, either directly or indirectly through the process of trying to guess which of our categories is likely to do best in the near future.

1964, Letter

Past price behaviour is of no relevance

It is obvious that the performance of a stock last year or last month is no reason, per se, to either own it or to not own it now. It is obvious that an inability to "get even" in a security that has declined is of no importance. It is obvious that the inner warm glow that results from having held a winner last year is of no importance in making a decision as to whether it belongs in an optimum portfolio this year.

1964, Letter

In short term demand and supply drive prices, in long term earnings power

value. When a small minority interest in a company is held, earning power and assets are, of course, very important, but they represent an indirect influence on value which, in the short run, may or may not dominate the factors bearing on supply and demand which result in price.

1965, Letter

Asset Allocation

Asymmetric allocation

Presently this investment is about 35% of assets.

1959, Letter

Use mathematical expectation and it's wideness to allocate

always is, "How much do I put in number one (ranked by expectation of relative performance) and how much do I put in number eight?" This depends to a great degree on the wideness of the spread between the mathematical expectation of number one versus number eight." It also depends upon the probability that number one could turn in a really poor relative performance. Two securities could have equal mathematical expectations, but one might have .05 chance of performing fifteen percentage points or more worse than the Dow, and the second might have only .01 chance of such performance. The wider range of expectation in the first case reduces the desirability of heavy concentration in it.

1965 Letter

Qualities to look for in business

Monopoly, recession proof

For seventy-five years the business operated in a more or less monopolistic manner, with profits realized in every year accompanied by almost complete immunity to recession and lack of need for any sales effort. In

1960, Letter

What works in Investing

Buy the right Company

"Buy the right company (with the right prospects, inherent industry conditions, management, etc.) and the price will take care of itself."

1967, Letter

Buy the right Price

"Buy at the right price and the company (and stock) will take care of itself."

1967, Letter

Moat building activities

Expenditure on sales and promotion

by “mapping” companies. However, the means of selling and packaging Sanborn’s product, information had remained unchanged throughout the year and finally this inertia was reflected in the earnings.

1960, Letter

When to Sell

When a security reaches Fair Value

We do not go into these generals with the idea of getting the last nickel, but are usually quite content selling out at some intermediate level between our purchase price and what we regard as fair value to a private owner.

1963, Letter

Sell when valuations catch up

even though alternative investments offered an expectable higher rate of return. More money would be made buying businesses at attractive prices, then reselling them. However, it may be more enjoyable (particularly

1967, Letter

Use of Leverage

Utilise leverage in portfolio

may be in ten to fifteen of these; some just beginning and others in the late stage of their development. I believe in using borrowed money to offset a portion of our work-out portfolio since there is a high degree of safety in this category in terms of both eventual results and intermediate market behavior. Results, excluding the benefits

1963, Letter

In both cases, the return is computed on an all equity investment. I definitely feel some borrowed money is warranted against a portfolio of workouts, but feel it is a very dangerous practice against generals.

1964, Letter

Valuations

What is not value

portion of their interest based upon the same price. The estimated value should not be what we hope it would be worth, or what it might be worth to an eager buyer, etc., but what I would estimate our interest would bring if sold under current conditions in a reasonably short period of time. Our efforts will be devoted toward increasing

1963, Letter

Book value a better measure than next year PE

above ground (and part of it underground) is profit. My security analyst friends may find this a rather primitive method of accounting, but I must confess that I find a bit more substance in this fingers and toes method than in any prayerful reliance that someone will pay me 35 times next year's earnings.

1964, Letter

Buy out of favour stock at bargain price to a private owner

nothing to indicate immediate market improvement. The issues lack glamour or market sponsorship. Their main qualification is a bargain price; that is, an overall valuation on the enterprise substantially below what careful analysis indicates its value to a private owner to be. Again let me emphasize that

1964, Letter

What drives value – assets, Earnings power and industry conditions

to their holdings -I feel I would need something at least that reliable to sleep well at present prices.) I attempt to apply a conservative valuation based upon my knowledge of assets, earning power, industry conditions, competitive position, etc. We would not be a seller of our holdings at such a figure, but neither would we be a

1965, Letter

Selling below Value to a Private owner

At that time, and for some years subsequently, there were substantial numbers of securities selling at well below the "value to a private owner" criterion we utilized for selection of general market investments. We also

1967, Letter

Management is key to investing

Management is important in spite of good numbers

while the quantitative comes first and is essential, the qualitative is important. We like good management - we like a decent industry - we like a certain amount of "ferment" in a previously dormant management or stockholder group. But we demand value. The general group behaves very much in

1964, Letter

How a business turnarounds

Reduce Inventory

(1) took the inventory from over \$4 million (much of it slow moving) to under \$1 million reducing carrying costs and obsolescence risks tremendously;

Free up Capital, reduce working capital and capex

(2) correspondingly freed up capital for marketable security purchases from which we gained

Cut overhead

(3) cut administration and selling expense from \$150,000 to \$75,000 per month;

(4) cut factory overhead burden from \$6 to \$4.50 per direct labor hour;

Close inappropriate franchise

(5) closed the five branches operating unprofitably (leaving us with three good ones) and replaced them with more productive distributors;

(6) cleaned up a headache at an auxiliary factory operation at Columbus, Nebraska;

(7) eliminated jobbed lines tying up considerable money (which could be used profitably in securities) while producing no profits;

Improve Earnings power

- (8) adjusted prices of repair parts, thereby producing an estimated \$200,000 additional profit with virtually no loss of volume; and most important;
- (9) through these and many other steps, restored the earning capacity to a level commensurate with the capital employed.

~1964, Dempester case study

Diversification

Bet hard when things are in your favour

reading, "7. We diversify substantially less than most investment operations. We might invest up to 40% of our net worth in a single security under conditions coupling an extremely high probability that our facts and reasoning are correct with a very low probability that anything could drastically change the underlying value of the investment."

Partnership is not the place for you. We are obviously only going to go to 40% in very rare situations - this rarity, of course, is what makes it necessary that we concentrate so heavily, when we see such an opportunity. We probably have had only five or six situations in the nine-year history of the Partnership where we have exceeded 25%. Any such situations are going to have to promise very significantly superior performance

1965, Letter

Consequences of wide diversification

The optimum portfolio depends on the various expectations of choices available and the degree of variance in performance which is tolerable. The greater the number of selections, the less will be the average year-to-year variation in actual versus expected results. Also, the lower will be the expected results, assuming different choices have different expectations of performance.

1965, Letter

Why typical money managers fail

way reflects lack of either intellectual capacity or integrity. I think it is much more the product of: (1) group decisions - my perhaps jaundiced view is that it is close to impossible for outstanding investment management to come from a group of any size with all parties really participating in decisions; (2) a desire to conform to the policies and (to an extent) the portfolios of other large well-regarded organizations; (3) an institutional framework whereby average is "safe" and the personal rewards for independent action are in no way commensurate with the general risk attached to such action; (4) an adherence to certain diversification practices which are irrational; and finally and importantly, (5) inertia.

1964, Letter

What businesses to avoid

Business dependent on trickle of ideas

It is obvious that a business based upon only a trickle of fine ideas has poorer prospects than one based upon a steady flow of such ideas. To date the trickle has provided as much financial nourishment as the flow. This is

1967, Letter

Business with a human issue

Finally, we will not seek out activity in investment operations, even if offering splendid profit expectations, where major human problems appear to have a substantial chance of developing.

1967, Letter

Book Recommendations

The money Game by Adam Smith (1968, Letter)