CLIENT LETTER MARCH 2008

J. BARTON RILEY, CFA

# "We'll Be Fine"

When stock prices seemingly decline every day, it is easy to become transfixed watching their short-term price movements, and, as always, the newspapers and financial news networks do an excellent job reporting and exacerbating the market's trend. Thus, it was something of a miracle to find the CNBC show, *Squawk Box*, featuring an interview with Warren Buffett on March 3rd of this year. (A transcript of the entire three hour interview is available on the CNBC web site (Click here for the hyperlink).) As you might suspect, Mr. Buffett had lots of good long-term advice, and he demonstrated little concern about the short-term price movements that dominate most of our current fears.

Worried about the future? Here is Buffett's response to the interviewer's question about whether "we'll be OK down the road?"

> "...We'll be fine. I mean the factories don't go away, the people and their talents don't go away, the houses don't go away, the population grows. No, over time, my children are going to live better than I do, although they don't seem to think so. ...we have a market system, we have a meritocracy, we have the rule of law. None of them [are] perfect, but they have combined in the past to move one generation after another ahead of the one that preceded them."[i]

I suggest that we all print this answer out on a small piece of paper and carry it around with us in case of emergency. When we get anxious about short-term price movements, we can stop and reread Buffett's antidote for excessive fretting, and then get back to investing for the long-term.

Before the interviewer could ask another question, Buffett continues to address the gyrations of the markets,

> “But it will also be the case that markets will do very wild, unpredictable things and you will see things that you haven’t seen before in the markets. That’s the way people make markets, and they’re not rational much of the time.”[ii]

I wrote about the fallacy of rational markets in my last letter so I’ll let this quote speak for itself. However, I do need to acknowledge that Mr. Buffett has been poking fun at the academics’ assumption of market rationality since before it became acceptable to do so. In fact, just about everyone who questions the efficient market hypothesis uses Mr. Buffett’s forty-three year record of out-performance as the prime example of the market’s inefficiency.

While he was on the topic of irrational markets, Mr. Buffett even rises to the defense of CNBC and its peers,

> “…you are reporting spot news all the time…the problem is the way people react.”[iii]

So, my implicit criticism of CNBC in the first paragraph is unjust! It’s my fault, and your fault, too. The current market declines are caused by “people” not the media.

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It is enlightening to have Warren Buffett on television, but television’s short question and answer segments don’t afford viewers the chance to fully delve into any one subject. We are left with a great deal of cursory knowledge, but little deep understanding. Warren Buffett’s ‘hard-core’ followers always plan their March schedules around the release of his annual letter to the shareholders of Berkshire Hathaway (3/14/08 px. $129,360/sh) . In the ‘old days’ you had to be an actual shareholder and wait patiently for the postman to deliver your printed annual report. In today’s wired world, you can access the letter online at the Berkshire Hathaway website (hyperlink). And so, on Saturday, March 5th, we had a new twenty-two page letter to read and digest as we searched for new nuggets of investment wisdom.

In this year's letter, Mr. Buffett does not want to remind us of his previous warnings about the power of derivatives to become 'weapons of financial mass destruction'. So, in his tasteful way, he found a proxy to say the same thing. He quotes John Stumpf, CEO of Wells Fargo,

> "It is interesting that the industry [banking and finance] has invented new ways to lose money when the old ways seemed to work just fine."[iv]

Referencing the bubble in housing prices and the "folly" of mortgage lenders affords Buffett the opportunity to revisit one of his favorite aphorisms, "You only learn who has been swimming naked when the tide goes out," however this year he added the timely update, "…and what we are witnessing at some of our largest financial institutions is an ugly sight."[v] I don't think that many bankers will earn a passing grade from Mr. Buffett for their work over the past few years.

This year's letter to shareholders does not address directly the issue of executive compensation at banks or public companies. Often in past letters, Buffett has discussed the amazing ability of corporate boards to reward mediocre (or even 'bad') management teams with large bonuses and huge stock option grants. However, this year, he chooses to address what he sees as Berkshire's competitive advantage: its ability to acquire top managers, who choose to sell their businesses to Berkshire with the intent of remaining at their posts,

> "Many sold us their businesses for large sums and run them because they love doing so…they have exactly the job they want for the rest of their working years. …Their decisions flow from a here-today, here-forever mindset. I think our rare and hard-to-replicate managerial structure gives Berkshire a real advantage."[vi]

I hope that future letters from Mr. Buffett will include some additional thoughts on how to instill a "here-forever" mindset in the senior executives of other public companies. The management compensation segments of the 2008 proxy statements currently arriving in our mailboxes are, with a few meaningful exceptions, examples of 'here-today, gone-tomorrow' personal income maximization schemes.

The best segment of the Berkshire shareholder letter begins on page six and is titled, "Businesses- The Great, the Good and the Gruesome." For long-term Berkshire shareholders, there isn't anything particularly new here. But at a time when all of us are probably too focused on the short-term, we need to remember the basics of investing:

> "Charlie and I look for companies that have a) a business we understand; b) favorable long-term economics; c) able and trustworthy management; and d) a sensible price tag"...A truly great business must have an enduring "moat" that protects excellent returns on invested capital. The dynamics of capitalism guarantee that competitors will repeatedly assault any business "castle" that is earning high returns."[vii]

Following this introduction, Buffett writes a salute to his long-term ownership of 'See's Candy', which he bought for $25 million in 1972. Thirty-five years later, the same business earned $82 million (pre-tax). And, in order to deserve the "Great" appellation, the wonderful truth is that over the intervening thirty-five years, Berkshire's ***cumulative*** additional investment in See's was a mere $32 million.

To illustrate the 'Good', Buffett writes about Berkshire's 'FlightSafety', which operates the premier flight simulation business; designed to insure that aircraft pilots may both learn and retain their skills. In this kind of 'good' business, the owners make plenty of money but they have to reinvest a large portion of the profits back into their business in order to insure its long-term well-being.

Finally, to describe a 'Gruesome' business, Buffett looks back upon his foolish investment in U.S. Airlines where he managed to escape with a profit before the company went bankrupt – "twice".

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My recent favorite nugget of Buffett wisdom did not come from his recent letter to shareholders. Instead I found it on an internet 'blog' written by a business school student at Emory University (hyperlink), whose class took a trip to Omaha to visit Warren Buffett at Berkshire's offices,

> "I spend my time thinking about the future, not the past. The future is exciting. As Bertrand Russell says, 'Success is getting what you want; happiness is wanting what you get."… We're all successful, intelligent, educated. To focus on what you don't have is a terrible mistake. With the gifts all of us have, if you are unhappy, it's your own fault."[viii]

We'll be fine.

*The opinions expressed in this Commentary are those of Barton Investment Management, LLC. These views are subject to change at any time based on market and other conditions, and no forecasts can be guaranteed.*

*The reported numbers enclosed are derived from sources believed to be reliable. However, we cannot guarantee their accuracy. Past performance does not guarantee future results.*

*A current copy of our ADV Part II is available upon request.*

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[i] "Warren Buffett Answers Your Emails on Squawk Box: Transcript (Part 5)" CNBC.com. 3 March 2008. 6 March 2008. <http://www.cnbc.com/id/23450595>

[ii] ibid.

[iii] "Warren Buffett Answers Your Emails on Squawk Box: Transcript (Part 6)" CNBC.com. 3 March 2008. 6 March 2008. <http://www.cnbc.com/id/23450713>

[iv] Buffett, Warren E. 2007 Berkshire Hathaway Shareholders Letter. February 2008. p.3. <http://www.berkshirehathaway.com/letters/2007ltr.pdf>

[v] ibid. p.3.

[vi] ibid. p.4.

[vii] ibid. p.6.

[viii] Le, Dang. "Notes from Buffett Meeting 2/15/2008" Weblog Entry. Underground Value. 2 February 2008. 5 March 2008 <http://undergroundvalue.blogspot.com/2008/02/notes-from-buffett-meeting-2152008_23.html>