The Year That Was: Buffett's 2002

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One of the highlights each year for investors is the release of Warren Buffett's *Letter to Shareholders* in the annual report of Berkshire Hathaway. Within days of its release each March, articles based on Buffett's letter appear in newspapers and magazines around the world.

Why are people so interested in what he has to say? In a nutshell, because he is the world's greatest investor. Since taking over Berkshire Hathaway in 1965, its value has increased by 214,433 percent or 22.2 percent per year. In contrast, the S&P500 has grown by 3,633 percent or 10.0 percent per year.

Different people look for different things in his *Letter*. What he has been buying and selling, what his opinion is of the market, and his principles of investing. Let's look at each of these three.

Buying and Selling

Some simply want to see what Warren Buffett has bought, or sold, in the past year. Their aim is to see if they can benefit from this with their own portfolio. This can be very dangerous as Margie Baldock explains in her article *Top 3 Mistakes Made byWarren Buffett Wannabes.*

Buffett is very secretive about his share transactions. He has written many times that his opinions about specific stocks translate into profits for Berkshire Hathaway. And he not about to jeopardize that.

In the annual report he only lists details of those holdings above $500 million. Even then he usually doesn't say whether he has been increasing or decreasing his holdings. By searching the Securities and Exchange Commission filings sometimes you can gain extra information.

For a start, Buffett may have sold a stake he recently acquired in advertising firm Omnicom Group Inc. He listed no holdings in Omnicom in a recent filing for the end of 2002. Yet, he listed 500,000 shares in his previous report on holdings at the end of September.

A change in holdings listed by Buffett usually indicates a purchase or sale, but occasionally Buffett gets permission from the SEC to withhold information on stock trades.

According to other filing, Berkshire Hathaway listed new holdings in retailer Best Buy, bank PNC Financial Services Group and finance and technology firms Comdisco Holding and First Data Corp. Also a greater holding of shares in record storage firm Iron Mountain.

Buffett lowered his stake in copper tube maker Mueller Industries to 7.24 percent from 9.62 percent, according to another filing. At the end of 2002, Buffett held 2.5 million common shares of Mueller, down from 3.2 million shares as of Dec. 31, 2001.

Market Opinion

Usually Buffett makes no comment about the overall direction of the market. Recently he said, "I never have the faintest idea what the stock market is going to do in the next six months, or the next year, or the next two." (Fortune, December 10, 2001.)

Occasionally he will make comments about the overall value of the market. But in the end, he usually comes back to the comment that we are not really investing in the market; we are investing in individual companies.

When the value of a company is high in relation to its price, then Buffett is interested. The only thing that changes over time is the number of companies that meet these criteria. Sometimes you have to work a little harder to find them.

In the current "Letter" Buffett writes that "we still find very few [stocks] that even mildly interest us". He often, however, makes this type of comment and then a few months later we find out just how active he has been in buying stocks. The examples in the previous section show that he has been reasonably active—and these are only the transactions that we know about.

There are other reasons why Buffett's comments about the overall market should not be taken as binding. Firstly, the universe of companies in which Buffett can invest is very limited. At a recent shareholders meeting he said that unless he can invest at least $500m and preferably $1 bilion, he is not really interested. He then continued by saying that this means that he would really only invest in a public company if it had a market capitalization of over $10 billion.

We do not have that restriction. For example, there are around 180 securities with market cap over $10 billion. Even if we only want to invest in companies with market cap over $1 billion, we can choose from around 820 securities.

Secondly, Buffett only invests in his area of expertise. Each individual investor has his or her own area of expertise.

Thirdly, even if it is not possible to find anything that meets all your requirements right at the moment, it is very important to have done as much analysis as possible in advance. Then you are ready to take any opportunities.

Conscious Investor® shows how to set target prices to but the stock you want at the price that you are willing to pay. This means that if there is a drop in price to your target price, you will be ready to take action.

Principles of Investing

Each of Buffett's "Letters" contains principles of investing. These are timeless principles brought to a new level of immediacy by Buffett's experience, concern and humor.

In the current Letter Buffett writes extensively about corporate governance. In particular, how accountability and stewardship by the members of the boards of public companies has "withered in the last decade"

This is something that is strongly felt by many investors. Buffett does give us something extra. He says that although we need directors who think and speak independently, he says that they must have three other qualities: business-savvy, interested and shareholder oriented.

This gives us a framework for evaluating the members of a board of any company that we might be considering as an addition to our portfolio.

With the new rules that have been proposed by the SEC for board membership it is likely that Berkshire Hathaway will need to add new directors. Buffett explained that he will he will look through the shareholders list for people who have had large Berkshire holdings for a long period of time. This, he asserts, would take care of the requirement that they would be interested in Berkshire and shareholder-oriented.

Buffett points out that he pays his directors a pittance—he wants their decisions to be based on how it will affect their net worth, not on their compensation.

Another interesting item is that Buffett explains that he unless he sees "a very high probability of at least 10% pre-tax returns," he will "sit on the sidelines."

We can follow this strategy using the analysis in Conscious Investor. Invest in companies that have a forecast return (STRET or STRETD) of 10% in the Scenario Analysis with a high margin of safety.

In this way we can be reasonably confident of at least a return of 10% while leaving open the upside potential. Of course, nothing is guaranteed. But in Buffett's case the upside potential has resulted in average returns of 20% and more over the years.

The moral of this is that there is much to be learned for every investor from a careful reading of Buffett's letters to shareholders. Not so much in terms of what he is buying or selling, but in how he goes about making these decisions.

This usefulness is even greater for subscribers to Conscious Investor because of the way it is designed as a tool for implementing Buffett's investment principles and methods.

