1957 Letter
WARREN E. BUFFETT
5202 Underwood Ave. Omaha, Nebraska

SECOND ANNUAL LETTER TO LIMITED PARTNERS

The General Stock Market Picture in 1957

In last year's letter to partners, I said the following:

My view of the general market level is that it is priced above intrinsic value. This view relates to blue-chip securities. This view, if accurate, carries with it the possibility of a substantial decline in all stock prices, both undervalued and otherwise. In any event I think the probability is very slight that current market levels will be thought of as cheap five years from now. Even a full-scale bear market, however, should not hurt the market value of our work-outs substantially.

If the general market were to return to an undervalued status our capital might be employed exclusively in general issues and perhaps some borrowed money would be used in this operation at that time. Conversely, if the market should go considerably higher our policy will be to reduce our general issues as profits present themselves and increase the work-out portfolio.

All of the above is not intended to imply that market analysis is foremost in my mind. Primary attention is given at all times to the detection of substantially undervalued securities.

The past year witnessed a moderate decline in stock prices. I stress the word "moderate" since casual reading of the press or conversing with those who have had only recent experience with stocks would tend to create an impression of a much greater decline. Actually, it appears to me that the decline in stock prices has been considerably less than the decline in corporate earning power under present business conditions. This means that the public is still very bullish on blue chip stocks and the general economic picture. I make no attempt to forecast either business or the stock market; the above is simply intended to dispel any notions that stocks have suffered any drastic decline or that the general market, is at a low level. I still consider the general market to be priced on the high side based on long term investment value.

Our Activities in 1957

The market decline has created greater opportunity among undervalued situations so that, generally, our portfolio is heavier in undervalued situations relative to work-outs than it was last year. Perhaps an explanation of the term "work-out" is in order. 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 applecart and cause the abandonment of the planned action, not that the economic picture will deteriorate and stocks decline generally. At the end of 1956, we had a ratio of about 70-30 between general issues and work-outs. Now it is about 85-15.

During the past year we have taken positions in two situations which have reached a size where we may expect to take some part in corporate decisions. One of these positions accounts for between 10% and 20% of the portfolio of the various partnerships and the other accounts for about 5%. Both of these will probably take in the neighborhood of three to five years of work but they presently appear to have potential for a high average annual rate of return with a minimum of risk. While not in the classification of work-outs, they have very little dependence on the general action of the stock market. Should the general market have a substantial rise, of course, I would expect this section of our portfolio to lag behind the action of the market.

Results for 1957

In 1957 the three partnerships which we formed in 1956 did substantially better than the general market. At the beginning of the year, the Dow-Jones Industrials stood at 499 and at the end of the year it was at 435 for a loss of 64 points. If one had owned the Averages, he would have received 22 points in dividends reducing the overall loss to 42 points or 8.470% for the year. This loss is roughly equivalent to what would have been achieved by investing in most investment funds and, to my knowledge, no investment fund invested in stocks showed a gain for the year.

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. The third partnership was started the latest in 1956 when the market was at a lower level and when several securities were particularly attractive. Because of the availability of funds, large positions were taken in these issues. Whereas the two partnerships formed earlier were already substantially invested so that they could only take relatively small positions in these issues.

Basically, all partnerships are invested in the same securities and in approximately the same percentages. However, particularly during the initial stages, money becomes available at varying times and varying levels of the market so there is more variation in results than is likely to be the case in later years. Over the years, I will be quite satisfied with a performance that is 10% per year better than the Averages, so in respect to these three partnerships, 1957 was a successful and probably better than average, year.

Two partnerships were started during the middle of 1957 and their results for the balance of the year were roughly the same as the performance of the Averages which were down about 12% for the period since inception of the 1957 partnerships. Their portfolios are now starting to approximate those of the 1956 partnerships and performance of the entire group should be much more comparable in the future.

Interpretation of results

To some extent our better than average performance in 1957 was due to the fact that it was a generally poor year for most stocks. Our performance, relatively, is likely to be better in a bear market than in a bull market so that deductions made from the above results should be tempered by the fact that it was the type of year when we should have done relatively well. In a year when the general market had a substantial advance I would be well satisfied to match the advance of the Averages.

I can definitely say that our portfolio represents better value at the end of 1957 than it did at the end of 1956. This is due to both generally lower prices and the fact that we have had more time to acquire the more substantially undervalued securities which can only be acquired with patience. Earlier I mentioned our largest position which comprised 10% to 20% of the assets of the various partnerships. In time I plan to have this represent 20% of the assets of all partnerships but this cannot be hurried. 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.

I have tried to cover points which I felt might be of interest and disclose as much of our philosophy as may be imparted without talking of individual issues. If there are any questions concerning any phase of the operation, I would welcome hearing from you.

1958 Letter
Warren E Buffett
5202 Underwood Ave. Omaha, Nebraska

THE GENERAL STOCK MARKET IN 1958

A friend who runs a medium-sized investment trust recently wrote: "The mercurial temperament, characteristic of the American people, produced a major transformation in 1958 and 'exuberant' would be the proper word for the stock market, at least".

I think this summarizes the change in psychology dominating the stock market in 1958 at both the amateur and professional levels. During the past year almost any reason has been seized upon to justify "Investing" in the market. There are undoubtedly more mercurially-tempered people in the stock market now than for a good many years and the duration of their stay will be limited to how long they think profits can be made quickly and effortlessly. While it is impossible to determine how long they will continue to add numbers to their ranks and thereby stimulate rising prices, I believe it is valid to say that the longer their visit, the greater the reaction from it.

I make no attempt to forecast the general market - my efforts are devoted to finding undervalued securities. However, I do believe that widespread public belief in the inevitability of profits from investment in stocks will lead to eventual trouble. Should this occur, prices, but not intrinsic values in my opinion, of even undervalued securities can be expected to be substantially affected.

RESULTS IN 1958

In my letter of last year, I wrote:

> "Our performance, relatively, is likely to be better in a bear market than in a bull market so that deductions made from the above results should be tempered by the fact that it was the type of year when we should have done relatively will. In a year when the general market had a substantial advance, I would be well satisfied to match the advance of the averages."

The latter sentence describes the type of year we had in 1958 and my forecast worked out. The Dow-Jones Industrial average advanced from 435 to 583 which, after adding back dividends of about 20 points, gave an overall gain of 38.5% from the Dow-Jones unit. The five partnerships that operated throughout the entire year obtained results averaging slightly better than this 38.5%. Based on market values at the end of both years, their gains ranged from 36.7% to 46.2%. Considering the fact that a substantial portion of assets has been and still is invested in securities, which benefit very little from a fast-rising market, I believe these results are reasonably good. I will continue to forecast that our results will be above average in a declining or level market, but it will be all we can do to keep pace with a rising market.

TYPICAL SITUATION

So that you may better understand our method of operation, I think it would be well to review a specific activity of 1958. Last year I referred to our largest holding which comprised 10% to 20% of the assets of the various partnerships. I pointed out that it was to our interest to have this stock decline or remain relatively steady, so that we could acquire an even larger position and that for this reason such a security would probably hold back our comparative performance in a bull market.

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. So here we had a very well managed bank with substantia1 earnings power selling at a large discount from intrinsic value. Management was friendly to us as new stockholders and risk of any ultimate loss seemed minimal.

Commonwealth was 25.5% owned by a larger bank (Commonwealth had assets of about $50 Million – about half the size of the First National in Omaha), which had desired a merger for many years. Such a merger was prevented for persona1 reasons, but there was evidence that this situation would not continue indefinitely. Thus we had a combination of:

1. Very strong defensive characteristics;
2. Good solid value building up at a satisfactory pace and;
3. Evidence to the effect that eventually this value would be unlocked although it might be one year or ten years. If the latter were true, the value would presumably have been built up to a considerably larger figure, say, $250 per share.

Over a period of a year or so, we were successful in obtaining about 12% of the bank at a price averaging about $51 per share. Obviously it was definitely to our advantage to have the stock remain dormant in price. Our block of stock increased in value as its size grew, particularly after we became the second largest stockholder with sufficient voting power to warrant consultation on any merger proposa1.

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.

Unfortunately we did run into some competition on buying, which railed the price to about $65 where we were neither buyer nor seller. Very small buying orders can create price changes of this magnitude in an inactive stock, which explains the importance of not having any "Leakage" regarding our portfolio holdings.

Late in the year we were successful in finding a special situation where we could become the largest holder at an attractive price, so we sold our block of Commonwealth obtaining $80 per share although the quoted market was about 20% lower at the time.

It is obvious that we could still be sitting with $50 stock patiently buying in dribs and drabs, and I would be quite happy with such a program although our performance relative to the market last year would have looked poor. The year when a situation such at Commonwealth results in a realized profit is, to a great extent, fortuitous. Thus, our performance for any single year has serious limitations as a basis for estimating long term 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.

I might mention that the buyer of the stock at $80 can expect to do quite well over the years. However, the relative undervaluation at $80 with an intrinsic value $135 is quite different from a price $50 with an intrinsic value of $125, and it seemed to me that our capital could better be employed in the situation which replaced it. This new situation is somewhat larger than Commonwealth and represents about 25% of the assets of the various partnerships. While the degree of undervaluation is no greater than in many other securities we own (or even than some) we are the largest stockholder and this has substantial advantages many times in determining the length of time required to correct the undervaluation. In this particular holding we are virtually assured of a performance better than that of the Dow-Jones for the period we hold it.

THE CURRENT SITUATION

The higher the level of the market, the fewer the undervalued securities and I am finding some difficulty in securing an adequate number of attractive investments. I would prefer to increase the percentage of our assets in work-outs, but these are very difficult to find on the right terms.

To the extent possible, therefore, I am attempting to create my own work-outs by acquiring large positions in several undervalued securities. Such a policy should lead to the fulfillment of my earlier forecast – an above average performance in a bear market. It is on this basis that I hope to be judged. If you have any questions, feel free to ask them.

WARREN E. BUFFETT 2-11-59

1959 Letter
WARREN E. BUFFETT
5202 Underwood Ave. Omaha, Nebraska

The General Stock Market in 1959:

The Dow-Jones Industrial Average, undoubtedly the most widely used index of stock market behavior, presented a somewhat faulty picture in 1959. This index recorded an advance from 583 to 679, or 16.4% for the year. When the dividends which would have been received through ownership of the average are added, an overall gain of 19.9% indicated for 1959.

Despite this indication of a robust market, more stocks declined than advanced on the New York Stock Exchange during the year by a margin of 710 to 628. Both the Dow-Jones Railroad Average and Utility Average registered declines.

Most investment trusts had a difficult time in comparison with the Industrial Average. Tri-Continental Corp. the nation's largest closed-end investment company (total asset $400 million) had an overall gain of about 5.7% for the year. Fred Brown, its President, had this to say about the 1959 marked in a recent speech to the Analysts Society:

> "But, even though we like the portfolio, the market performance of Tri-Continental's holdings in 1959 was disappointing to us. Markets in which investor sentiment and enthusiasm play so large a part as those of 1959, are difficult for investment managers trained in values and tuned to investing for the long-term. Perhaps we haven't had our space boots adjusted properly. However, we believe that there is a limit to risks that an investing institution such as Tri-Continental should take with its stockholders' money, and we believe that the portfolio is in shape for the year ahead."

Massachusetts Investors Trust, the country's largest mutual fund with assets of $1.5 billion showed an overall gain of about 9% for the year.

Most of you know I have been very apprehensive about general stock market levels for several years. To date, this caution has been unnecessary. By previous standards, the present level of "blue chip" security prices contains a substantial speculative component with a corresponding risk of loss. Perhaps other standards of valuation are evolving which will permanently replace the old standard. I don't think so. I may very well be wrong; however, I would rather sustain the penalties resulting from over-conservatism than face the consequences of error, perhaps with permanent capital loss, resulting from the adoption of a "New Era" philosophy where trees really do grow to the sky.

Results in 1959:

There has been emphasis in previous letters on a suggested standard of performance involving relatively good results (compared to the general market indices and leading investment trusts) in periods of declining or level prices but relatively unimpressive results in rapidly rising markets.

We were fortunate to achieve reasonably good results in 1959. The six partnerships that operated throughout the year achieved overall net gains ranging from 22.3% to 30.0%, and averaging about 25.9%. Portfolios of these partnerships are now about 80%comparable, but there is some difference due to securities and cash becoming available at varying times, payments made to partners, etc. Over the past few years, there hasn't been any partnership which has consistently been at the top or bottom of performance from year to year, and the variance is narrowing as the portfolios tend to become comparable.

The overall net gain is determined on the basis of market values at the beginning and end of the year adjusted for payments made to partners or contributions received from them. It is not based on actual realized profits during the year, but is intended to measure the change in liquidating value for the year. It is before interest allowed to partners (where that is specified in the partnership agreement) and before any division of profit to the general partner, but after operating expenses.

The principal operating expense is the Nebraska Intangibles Tax which amounts to .4% of market value on practically all securities. Last year represented the first time that this tax had been effectively enforced and, of course penalized our results to the extent of .4%.

<u>The present portfolio:</u>

Last year, I mentioned a new commitment which involved about 25% of assets of the various partnerships. Presently this investment is about 35% of assets. This is an unusually large percentage, but has been made for strong reasons. In effect, this company is partially an investment trust owing some thirty or forty other securities of high quality. Our investment was made and is carried at a substantial discount from asset value based on market value of their securities and a conservative appraisal of the operating business.

We are the company's largest stockholder by a considerable margin, and the two other large holders agree with our ideas. The probability is extremely high that the performance of this investment will be superior to that of the general market until its disposition, and I am hopeful that this will take place this year.

The remaining 65% of the portfolio is in securities which I consider undervalued and work-out operations. To the extent possible, I continue to attempt to invest in situations at least partially insulated from the behavior of the general market.

This policy should lead to superior results in bear markets and average performance in bull markets. The first prediction may be subject to test this year since, at this writing, the Dow-Jones Industrials have retraced over half of their 1959 advance.

Should you have any questions or if I have not been clear in any respect, I would be very happy to hear from you.

Warren E. Buffett
2-20-60

1960 Letter
WARREN E. BUFFETT
5202 Underwood Ave. Omaha, Nebraska

The General Stock Market in 1960:

A year ago, I commented on the somewhat faulty picture presented in 1959 by the Dow-Jones Industrial Average which had advanced from 583 to 679, or 16.4%. Although practically all investment companies showed gains for that year, less than 10% of them were able to match or better the record of the Industrial Average. The Dow-Jones Utility Average had a small decline and the Railroad Average recorded a substantial one.

In 1960, the picture was reversed. The Industrial Average declined from 679 to 616, or 9.3%. Adding back the dividends which would have been received through ownership of the Average still left it with an overall loss of 6.3%. On the other hand, the Utility Average showed a good gain and, while all the results are not now available, my guess is that about 90% of all investment companies outperformed the Industrial Average. The majority of investment companies appear to have ended the year with overall results in the range of plus or minus 5%. On the New York Stock Exchange, 653 common stocks registered losses for the year while 404 showed gains.

Results in 1960:

My continual objective in managing partnership funds is to achieve a long-term performance record superior to that of the Industrial Average. I believe this Average, over a period of years, will more or less parallel the results of leading investment companies. Unless we do achieve this superior performance there is no reason for existence of the partnerships.

However, I have pointed out that any superior record which we might accomplish should not be expected to be evidenced by a relatively constant advantage in performance compared to the Average. Rather it is likely that if such an advantage is achieved, it will be through better-than-average performance in stable or declining markets and average, or perhaps even poorer- than-average performance in rising markets.

I would consider a year in which we declined 15% and the Average 30% to be much superior to a year when both we and the Average advanced 20%. Over a period of time there are going to be good and bad years; there is nothing to be gained by getting enthused or depressed about the sequence in which they occur. The important thing is to be beating par; a four on a par three hole is not as good as a five on a par five hole and it is unrealistic to assume we are not going to have our share of both par three's and par five's.

The above dose of philosophy is being dispensed since we have a number of new partners this year and I want to make sure they understand my objectives, my measure of attainment of these objectives, and some of my known limitations.

With this background it is not unexpected that 1960 was a better-than-average year for us. As contrasted with an overall loss of 6.3% for the Industrial Average, we had a 22.8% gain for the seven partnerships operating throughout the year. Our results for the four complete years of partnership operation after expenses but before interest to limited partners or allocation to the general partner are:

Year	Partnerships Operating Entire Year	Partnership Gain	Dow-Jones Gain
1957	3	10.4%	-8.4%
1958	5	40.9%	38.5%
1959	6	25.9%	19.9%

1960	7	22.8%	-6.3%

It should be emphasized again that these are the net results to the partnership; the net results to the limited partners would depend on the partnership agreement that they had selected.

The overall gain or loss is computed on a market to market basis. After allowing for any money added or withdrawn, such a method gives results based upon what would have been realized upon liquidation of the partnership at the beginning, of the year and what would have been realized upon liquidation at year end and is different, of course, from our tax results, which value securities at cost and realize gains or losses only when securities are actually sold.

On a compounded basis, the cumulative results have been:

Year	**Partnership Gain**	**Dow-Jones Gain**
1957	10.4%	-8.4%
1958	55.6%	26.9%
1959	95.9%	52.2%
1960	140.6%	42.6%

Although four years is entirely too short a period from which to make deductions, what evidence there is points toward confirming the proposition that our results should be relatively better in moderately declining or static markets. To the extent that this is true, it indicates that our portfolio may be more conservatively, although decidedly less conventionally, invested than if we owned "blue-chip" securities. During a strongly rising market for the latter, we might have real difficulty in matching their performance.

<u>Multiplicity of Partnerships:</u>

A preceding table shows that the family is growing. There has been no partnership which has had a consistently superior or inferior record compared to our group average, but there has been some variance each year despite my efforts to "keep all partnerships invested in the same securities and in about the same proportions. This variation, of course, could be eliminated by combining the present partnerships into one large partnership. Such a move would also eliminate much detail and a moderate amount of expense.

Frankly, I am hopeful of doing something along this line in the next few years. The problem is that various partners have expressed preferences for varying partnership arrangements. Nothing will be done without unanimous consent of partners.

<u>Advance Payments:</u>

Several partners have inquired about adding money during the year to their partnership. Although an exception has been made, it is too difficult to amend partnership agreements during mid-year where we have more than one family represented among the limited partners. Therefore, in mixed partnerships an additional interest can only be acquired at the end of the year.

We do accept advance payments during the year toward a partnership interest and pay interest at 6% on this payment from the time received until the end of the year. At that time, subject to amendment of the agreement by the partners, the payment plus interest is added to the partnership capital and thereafter participates in profits and losses.

<u>Sanborn Map:</u>

Last year mention was made of an investment which accounted for a very high and unusual proportion (35%) of our net assets along with the comment that I had some hope this investment would be concluded in 1960. This hope materialized. The history of an investment of this magnitude may be of interest to you.

Sanborn Map Co. is engaged in the publication and continuous revision of extremely detailed maps of all cities of the United States. For example, the volumes mapping Omaha would weigh perhaps fifty pounds and provide minute details on each structure. The map would be revised by the paste-over method showing new construction, changed occupancy, new fire protection facilities, changed structural materials, etc. These revisions would be done approximately annually and a new map would be published every twenty or thirty years when further pasteovers became impractical. The cost of keeping the map revised to an Omaha customer would run around $100 per year.

This detailed information showing diameter of water mains underlying streets, location of fire hydrants, composition of roof, etc., was primarily of use to fire insurance companies. Their underwriting departments, located in a central office, could evaluate business by agents nationally. The theory was that a picture was worth a thousand words and such evaluation would decide whether the risk was properly rated, the degree of conflagration exposure in an area, advisable reinsurance procedure, etc. The bulk of Sanborn's business was done with about thirty insurance companies although maps were also sold to customers outside the insurance industry such as public utilities, mortgage companies, and taxing authorities.

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 the earlier years of the business, the insurance industry became fearful that Sanborn's profits would become too great and placed a number of prominent insurance men on Sanborn's board of directors to act in a watch-dog capacity.

In the early 1950's a competitive method of under-writing known as "carding" made inroads on Sanborn's business and after-tax profits of the map business fell from an average annual level of over $500,000 in the late 1930's to under $100,000 in 1958 and 1959. Considering the upward bias in the economy during this period, this amounted to an almost complete elimination of what had been sizable, stable earning power.

However, during the early 1930's Sanborn had begun to accumulate an investment portfolio. There were no capital requirements to the business so that any retained earnings could be devoted to this project. Over a period of time, about $2.5 million was invested, roughly half in bonds and half in stocks. Thus, in the last decade particularly, the investment portfolio blossomed while the operating map business wilted.

Let me give you some idea of the extreme divergence of these two factors. In 1938 when the Dow-Jones Industrial Average was in the 100-120 range, Sanborn sold at $110 per share. In 1958 with the Average in the 550 area, Sanborn sold at $45 per share. Yet during that same period the value of the Sanborn investment portfolio increased from about $20 per share to $65 per share. This means, in effect, that the buyer of Sanborn stock in 1938 was placing a positive valuation of $90 per share on the map business ($110 less the $20 value of the investments unrelated to the map business) in a year of depressed business and stock market conditions. In the tremendously more vigorous climate of 1958 the same map business was evaluated at a minus $20 with the buyer of the stock unwilling to pay more than 70 cents on the dollar for the investment portfolio with the map business thrown in for nothing.

How could this come about? Sanborn in 1958 as well as 1938 possessed a wealth of information of substantial value to the insurance industry. To reproduce the detailed information they had gathered over the years would have cost tens of millions of dollars. Despite "carding" over $500 million of fire premiums were underwritten 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.

The very fact that the investment portfolio had done so well served to minimize in the eyes of most directors the need for rejuvenation of the map business. Sanborn had a sales volume of about $2 million per year and owned about $7 million worth of marketable securities. The income from the investment portfolio was substantial, the business had no possible financial worries, the insurance companies were satisfied with the price paid for maps, and the stockholders still received dividends. However, these dividends were cut five times in eight years although I could never find any record of suggestions pertaining to cutting salaries or director's and committee fees.

Prior to my entry on the Board, of the fourteen directors, nine were prominent men from the insurance industry who combined held 46 shares of stock out of 105,000 shares outstanding. Despite their top positions with very large companies which would suggest the financial wherewithal to make at least a modest commitment, the largest holding in this group was ten shares. In several cases, the insurance companies these men ran owned small blocks of stock but these were token investments in relation to the portfolios in which they were held. For the past decade the insurance companies had been only sellers in any transactions involving Sanborn stock.

The tenth director was the company attorney, who held ten shares. The eleventh was a banker with ten shares who recognized the problems of the company, actively pointed them out, and later added to his holdings. The next two directors were the top officers of Sanborn who owned about 300 shares combined. The officers were capable, aware of the problems of the business, but kept in a subservient role by the Board of Directors. The final member of our cast was a son of a deceased president of Sanborn. The widow owned about 15,000 shares of stock.

In late 1958, the son, unhappy with the trend of the business, demanded the top position in the company, was turned down, and submitted his resignation, which was accepted. Shortly thereafter we made a bid to his mother for her block of stock, which was accepted. At the time there were two other large holdings, one of about 10,000 shares (dispersed among customers of a brokerage firm) and one of about 8,000. These people were quite unhappy with the situation and desired a separation of the investment portfolio from the map business, as did we.

Subsequently our holdings (including associates) were increased through open market purchases to about 24,000 shares and the total represented by the three groups increased to 46,000 shares. We hoped to separate the two businesses, realize the fair value of the investment portfolio and work to re-establish the earning power of the map business. There appeared to be a real opportunity to multiply map profits through utilization of Sanborn's wealth of raw material in conjunction with electronic means of converting this data to the most usable form for the customer.

There was considerable opposition on the Board to change of any type, particularly when initiated by an outsider, although management was in complete accord with our plan and a similar plan had been recommended by Booz, Allen & Hamilton (Management Experts). To avoid a proxy fight (which very probably would not have been forthcoming and which we would have been certain of winning) and to avoid time delay with a large portion of Sanborn’s money tied up in blue-chip stocks which I didn’t care for at current prices, a plan was evolved taking out all stockholders at fair value who wanted out. The SEC ruled favorably on the fairness of the plan. About 72% of the Sanborn stock, involving 50% of the 1,600 stockholders, was exchanged for portfolio securities at fair value. The map business was left with over $l,25 million in government and municipal bonds as a reserve fund, and a potential corporate capital gains tax of over $1 million was eliminated. The remaining stockholders were left with a slightly improved asset value, substantially higher earnings per share, and an increased dividend rate.

Necessarily, the above little melodrama is a very abbreviated description of this investment operation. However, it does point up the necessity for secrecy regarding our portfolio operations as well as the futility of measuring our results over a short span of time such as a year. Such control situations may occur very infrequently. Our bread-and-butter business is buying undervalued securities and selling when the undervaluation is corrected along with investment in special situations where the profit is dependent on corporate rather than market action. To the extent that partnership funds continue to grow, it is possible that more opportunities will be available in “control situations.”

The auditors should be mailing your financial statement and tax information within about a week. If you have any questions at all regarding either their report or this letter, be sure to let me know.

Warren E. Buffett 1-30-61

1960 Letter
BUFFETT PARTNERSHIP, LTD.
810 KIEWIT PLAZA
OMAHA 31, NEBRASKA

July, 1961

TO MY PARTNERS:

In the past, partners have commented that a once-a-year letter was “a long time between drinks,” and that a semi-annual letter would be a good idea. It really shouldn’t be too difficult to find something to say twice a year; at least it isn’t this year. Hence, this letter which will be continued in future years.

During the first half of 1961, the overall gain of the Dow-Jones Industrial Average was about 13%, including dividends. Although this is the type of period when we should have the most difficulty in exceeding this standard, all partnerships that operated throughout the six months did moderately better then the Average. Partnerships formed during 1961 either equaled or exceeded results of the Average from the time of formation, depending primarily on how long they were in operation.

Let me, however, emphasize two points. First, one year is far too short a period to form any kind of an opinion as to investment performance, and measurements based upon six months become even more unreliable. One factor that has caused some reluctance on my part to write semi-annual letters is the fear that partners may 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.

The second point I want everyone to understand is that if we continue in a market which advances at the pace of the first half of 1961, not only do I doubt that we will continue to exceed the results of the DJIA, but it is very likely that our performance will fall behind the Average.

Our holdings, which I always believe to be on the conservative side compared to general portfolios, tend to grow more conservative as the general market level rises. At all times, I attempt to have a portion of our portfolio in securities as least partially insulated from the behavior of the market, and this portion should increase as the market rises. However appetizing results for even the amateur cook (and perhaps particularly the amateur), we find that more of our portfolio is not on the stove.

We have also begun open market acquisition of a potentially major commitment which I, of course, hope does nothing marketwise for at least a year. Such a commitment may be a deterrent to short range performance, but it gives strong promise of superior results over a several year period combined with substantial defensive characteristics.

Progress has been made toward combining all partners at yearend. I have talked with all partners joining during this past year or so about this goal, and have also gone over the plans with representative partners of all earlier partnerships

Some of the provisions will be:

(A) A merger of all partnerships, based on market value at yearend, with provisions for proper allocation among partners of future tax liability due to unrealized gains at yearend. The merger itself will be tax-free, and will result in no acceleration of realization of profits;

(B) A division of profits between the limited partners and general partner, with the first 6% per year to partners based upon beginning capital at market, and any excess divided one-fourth to the general partner and three-fourths to all partners proportional to their capital. Any deficiencies in earnings below the 6% would be carried forward against future earnings, but would not be carried back. Presently, there are three profit arrangements which have been optional to incoming partners:

	Interest Provision	Excess to Gen. Partner	Excess to Ltd. Partners
(1)	6%	1/3	2/3
(2)	4%	1/4	3/4
(3)	None	1/6	5/6

In the event of profits, the new division will obviously have to be better for limited partners than the first two arrangements. Regarding the third, the new arrangement will be superior up to 18% per year; but above this rate the limited partners would do better under the present agreement. About 80% of total partnership assets have selected the first two arrangements, and I am hopeful, should we average better than 18% yearly, partners presently under the third arrangement will not feel short-changed under the new agreement;

(C) In the event of losses, there will be no carry back against amounts previously credited to me as general partner. Although there will be a carry-forward against future excess earnings. However, my wife and I will have the largest single investment in the new partnership, probably about one-sixth of total partnership assets, and thereby a greater dollar stake in losses than any other partner of family group, I am inserting a provision in the partnership agreement which will prohibit the purchase by me or my family of any marketable securities. In other words, the new partnership will represent my entire investment operation in marketable securities, so that my results will have to be directly proportional to yours, subject to the advantage I obtain if we do better than 6%;

(D) A provision for monthly payments at the rate of 6% yearly, based on beginning of the year capital valued at market. Partners not wishing to withdraw money currently can have this credited back to them automatically as an advance payment, drawing 6%, to purchase an additional equity interest in the partnership at yearend. This will solve one stumbling block that has heretofore existed in the path of consolidation, since many partners desire regular withdrawals and others wish to plow everything back;

(E) The right to borrow during the year, up to 20% of the value of your partnership interest, at 6%, such loans to be liquidated at yearend or earlier. This will add a degree of liquidity to an investment which can now only be disposed of at yearend. It is not intended that anything but relatively permanent funds be invested in the partnership, and we have no desire to turn it into a bank. Rather, I expect this to be a relatively unused provision, which is available when something unexpected turns up and a wait until yearend to liquidate part of all of a partner's interest would cause hardship;

(F) An arrangement whereby any relatively small tax adjustment, made in later years on the partnership's return will be assessed directly to me. This way, we will not be faced with the problem of asking eighty people, or more, to amend their earlier return over some small matter. As it stands now, a small change, such as a decision that a dividend received by the partnership has 63% a return of capital instead of 68%, could cause a multitude of paper work. To prevent this, any change amounting to less than $1,000 of tax will be charged directly to me.

We have submitted the proposed agreement to Washington for a ruling that the merger would be tax-free, and that the partnership would be treated as a partnership under the tax laws. While all of this is a lot of work, it will make things enormously easier in the future. You might save this letter as a reference to read in conjunction with the agreement which you will receive later in the year.

The minimum investment for new partners is currently $25,000, but, of course, this does not apply to present partners. Our method of operation will enable the partners to add or withdraw amounts of any size (in round $100) at yearend. Estimated total assets of the partnership will be in the neighborhood of $4 million, which enables us to consider investments such as the one mentioned earlier in this letter, which we would have had to pass several years ago.

This has turned out to be more of a production than my annual letter. If you have any questions, particularly regarding anything that isn't clear in my discussion of the new partnership agreement, be sure to let me know. If there are a large number of questions, I will write a supplemental letter to all partners giving the questions that arise and the answers to them.

Warren E. Buffett

Vlb
July 22, 1961

1961 Letter
BUFFETT PARTNERSHIP, LTD.
810 KIEWIT PLAZA
OMAHA 31, NEBRASKA

January 24, 1962

Our Performance in 1961

I have consistently told partners that it is my expectation and hope (it's always hard to tell which is which) that we will do relatively well compared to the general market in down or static markets, but that we may not look so good in advancing markets. In strongly advancing markets I expect to have real difficulty keeping up with the general market.

Although 1961 was certainly a good year for the general market, and in addition, a very good year for us on both an absolute and relative basis, the expectations in the previous paragraph remain unchanged.

During 1961, the general market as measured by the Dow-Jones Industrial Average (hereinafter called the "Dow") showed an over-all gain of 22.2% including dividends received through ownership of the Dow. The gain for all partnerships operating throughout the entire year, after all expenses of operation, but before payments to limited partners or accrual to the general partner, averaged 45.9%. The details of this gain by partnership are shown in the appendix along with results for the partnerships started during the year.

We have now completed five full years of partnership operation, and the results of these five years are shown below on a year-by-year basis and also on a cumulative or compounded basis. These results are stated on the basis described in the preceding paragraph; after expenses, but before division of gains among partners or payments to partners.

Year	**Partnerships Operating Entire Year**	**Partnership Gain**	**Dow-Jones Industrials Gain***
1957	3	10.4%	-8.4%
1958	5	40.9%	38.5%
1959	6	25.9%	19.9%
1960	7	22.8%	-6.3%
1961	7	45.9%	22.2%

* Including dividends received through ownership of the Dow.

On a compounded basis, the cumulative results have been:

Year	**Partnership Gain**	**Dow-Jones Industrials Gain**
1957	10.4%	-8.4%
1957-58	55.6%	26.9%
1057-59	95.9%	52.2%
1957-60	140.6%	42.6%
1957-61	251.0%	74.3%

These results do not measure the gain to the limited partner, which of course, is the figure in which you are most interested. Because of the varying partnership arrangements that have existed in the past, I have used the over-all net gain (based on market values at the beginning and end of the year) to the partnership as being the fairest measure of over-all performance.

On a pro-forma basis adjusted to the division of gains entailed in our present Buffett Partnership, Ltd. agreement, the results would have been:

Year	Limited Partners' Gain	Dow Gain
1957	9.3%	-8.4%
1958	32.2%	38.5%
1959	20.9%	19.9%
1960	18.6%	-6.3%
1961	35.9%	22.2%

COMPOUNDED

1957	9.3%	-8.4%
1957-58	44.5%	26.9%
1957-59	74.7%	52.2%
1957-60	107.2%	42.6%
1957-61	181.6%	74.3%

A Word About Par

The outstanding item of importance in my selection of partners, as well as in my subsequent relations with them, has been the determination that we use the same yardstick. If my performance is poor, I expect partners to withdraw, and indeed, I should look for a new source of investment for my own funds. If performance is good, I am assured of doing splendidly, a state of affairs to which I am sure I can adjust.

The rub, then, is in being sure that we all have the same ideas of what is good and what is poor. I believe in establishing yardsticks prior to the act; retrospectively, almost anything can be made to look good in relation to something or other.

I have continuously used the Dow-Jones Industrial Average as our measure of par. It is my feeling that three years is a very minimal test of performance, and the best test consists of a period at least that long where the terminal level of the Dow is reasonably close to the initial level.

While the Dow is not perfect (nor is anything else) as a measure of performance, it has the advantage of being widely known, has a long period of continuity, and reflects with reasonable accuracy the experience of investors generally with the market. I have no objection to any other method of measurement of general market performance being used, such as other stock market averages, leading diversified mutual stock funds, bank common trust funds, etc.

You may feel I have established an unduly short yardstick in that it perhaps appears quite simple to do better than an unmanaged index of 30 leading common stocks. Actually, this index has generally proven to be a reasonably tough competitor. Arthur Wiesenberger's classic book on investment companies lists performance for the 15 years 1946-60, for all leading mutual funds. There is presently over $20 billion invested in mutual funds, so the experience of these funds represents, collectively, the experience of many million investors. My own belief, though the figures are not obtainable, is that portfolios of most leading investment counsel organizations and bank trust departments have achieved results similar to these mutual funds.

Wiesenberger lists 70 funds in his "Charts & Statistics" with continuous records since 1946. I have excluded 32 of these funds for various reasons since they were balanced funds (therefore not participating fully in the general market rise), specialized industry funds, etc. Of the 32 excluded because I felt a comparison would not be fair, 31 did poorer than the Dow, so they were certainly not excluded to slant the conclusions below.

Of the remaining 38 mutual funds whose method of operation I felt was such as to make a comparison with the Dow reasonable, 32 did poorer than the Dow, and 6 did better. The 6 doing better at the end of 1960 had assets of about $1 billion, and the 32 doing poorer had assets of about $6-1/2 billion. None of the six that were superior beat the Dow by more than a few percentage points a year.

Below I present the year-by-year results for our period of operation (excluding 1961 for which I don't have exact data, although rough figures indicate no variance from the 1957-60 figures) for the two largest common stock open-end investment companies (mutual funds) and the two largest closed-end investment companies:

Year	**Mass. Inv. Trust**	**Investors Stock**	**Lehman**	**Tri-Cont.**	**Dow**	**Limited Partners**
1957	-12.0%	-12.4%	-11.4%	-2.4%	-8.4%	9.3%
1958	44.1%	47.6%	40.8%	33.2%	38.5%	32.2%
1959	8.2%	10.3%	8.1%	8.4%	19.9%	20.9%
1960	-0.9%	-0.1%	2.6%	2.8%	-6.3%	18.6%

(From Moody's Banks & Finance Manual, 1961)

COMPOUNDED

Year	**Mass. Inv. Trust**	**Investors Stock**	**Lehman**	**Tri-Cont.**	**Dow**	**Limited Partners**
1957	-12.0%	-12.4%	-11.4%	-2.4%	-8.4%	9.3%
1957-58	26.8%	29.3%	24.7%	30.0%	26.9%	44.5%
1957-59	37.2%	42.6%	34.8%	40.9%	52.2%	74.7%
1957-60	36.0%	42.5%	38.3%	44.8%	42.6%	107.2%

Massachusetts Investors Trust has net assets of about $1.8 billion; Investors Stock Fund about $1 billion; Tri - Continental Corporation about $ .5 billion; and Lehman Corporation about $350 million; or a total of over $3.5 billion.

I do not present the above tabulations and information with the idea of indicting investment companies. My own record of investing such huge sums of money, with restrictions on the degree of activity I might take in 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.

Our portfolio is very different from that of the Dow. Our method of operation is substantially different from that of mutual funds.

However, most partners, as all alternative to their investment in the partnership, would probably have their funds invested in a media producing results comparable to the Dow, therefore, I feel it is a fair test of performance.

<u>Our Method of Operation</u>

Our avenues of investment break down into three categories. These categories have different behavior characteristics, and the way our money is divided among them will have an important effect on our results, relative to the Dow in any given year. The actual percentage division among categories is to some degree planned, but to a great extent, accidental, based upon availability factors.

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.

Sometimes these work out very fast; many times they take years. It is difficult at the time of purchase to know any specific reason why they should appreciate in price. However, because of this lack of glamour or anything pending which might create immediate favorable market action, they are available at very cheap prices. A lot of value can be obtained for the price paid. This substantial excess of value creates a comfortable margin of safety in each transaction. This individual margin of safety, coupled with a diversity of commitments creates a most attractive package of safety and appreciation potential. Over the years our timing of purchases has been considerably better than our timing of sales. 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.

The generals tend to behave market-wise very much in sympathy with the Dow. Just because something is cheap does not mean it is not going to go down. During abrupt downward movements in the market, this segment may very well go down percentage-wise just as much as the Dow. Over a period of years, I believe the generals will outperform the Dow, and during sharply advancing years like 1961, this is the section of our portfolio that turns in the best results. It is, of course, also the most vulnerable in a declining market.

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 applecart. 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.

This category will produce reasonably stable earnings from year to year, to a large extent irrespective of the course of the Dow. Obviously, if we operate throughout a year with a large portion of our portfolio in work-outs, we will look extremely good if it turns out to be a declining year for the Dow or quite bad if it is a strongly advancing year. Over the years, work-outs have provided our second largest category. At any given time, we 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 derived from the use of borrowed money, usually fall in the 10% to 20% range. My self-imposed limit regarding borrowing is 25% of partnership net worth. Oftentimes we owe no money and when we do borrow, it is only as an offset against work-outs.

The final category is "control" situations where we either control the company or take a very large position and attempt to influence policies of the company. Such operations should definitely be measured on the basis of several years. In a given year, they may produce nothing as it is usually to our advantage to have the stock be stagnant market-wise for a long period while we are acquiring it. These situations, too, have relatively little in common with the behavior of the Dow. Sometimes, of course, we buy into a general with the thought in mind that it might develop into a control situation. If the price remains low enough for a long period, this might very well happen. If it moves up before we have a substantial percentage of the company's stock, we sell at higher levels and complete a successful general operation. We are presently acquiring stock in what may turn out to be control situations several years hence.

Dempster Mill Manufacturing Company

We are presently involved in the control of Dempster Mill Manufacturing Company of Beatrice, Nebraska. Our first stock was purchased as a generally undervalued security five years ago. A block later became available, and I went on the Board about four years ago. In August 1961, we obtained majority control, which is indicative of the fact that many of our operations are not exactly of the "overnight" variety.

Presently we own 70% of the stock of Dempster with another 10% held by a few associates. With only 150 or so other stockholders, a market on the stock is virtually non-existent, and in any case, would have no meaning for a controlling block. Our own actions in such a market could drastically affect the quoted price.

Therefore, it is necessary for me to estimate the value at yearend of our controlling interest. This is of particular importance since, in effect, new partners are buying in based upon this price, and old partners are selling a 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 this value, and we feel there are decent prospects of doing this.

Dempster is a manufacturer of farm implements and water systems with sales in 1961 of about $9 million. Operations have produced only nominal profits in relation to invested capital during recent years. This reflected a poor management situation, along with a fairly tough industry situation. Presently, consolidated net worth (book value) is about $4.5 million, or $75 per share, consolidated working capital about $50 per share, and at yearend we valued our interest at $35 per share. While I claim no oracular vision in a matter such as this, I feel this is a fair valuation to both new and old partners. Certainly, if even moderate earning power can be restored, a higher valuation will be justified, and even if it cannot, Dempster should work out at a higher figure. Our controlling interest was acquired at an average price of about $28, and this holding currently represents 21% of partnership net assets based on the $35 value.

Of course, this section of our portfolio is not going to be worth more money merely because General Motors, U.S. Steel, etc., sell higher. In a raging bull market, operations in control situations will seem like a very difficult way to make money, compared to just buying the general market. However, I am more conscious of the dangers presented at current market levels than the opportunities. Control situations, along with work-outs, provide a means of insulating a portion of our portfolio from these dangers.

The Question of Conservatism

The above description of our various areas of operation may provide some clues as to how conservatively our portfolio is invested. Many people some years back thought they were behaving in the most conservative manner by purchasing medium or long-term municipal or government bonds. This policy has produced substantial market depreciation in many cases, and most certainly has failed to maintain or increase real buying power.

Conscious, perhaps overly conscious, of inflation, many people now feel that they are behaving in a conservative manner by buying blue chip securities almost regardless of price-earnings ratios, dividend yields, etc. Without the benefit of hindsight as ill the bond example, I feel this course of action is fraught with danger. There is nothing at all conservative, in my opinion, about speculating as to just how high a multiplier a greedy and capricious public will put on earnings.

You will not be right simply because a large number of people momentarily agree with you. You will not be right simply because important people agree with you. In many quarters the simultaneous occurrence of the two above factors is enough to make a course of action meet the test of conservatism.

You will be right, over the course of many transactions, if your hypotheses are correct, your facts are correct, and your reasoning is correct. True conservatism is only possible through knowledge and reason.

I might add that in no way does the fact that our portfolio is not conventional prove that we are more conservative or less conservative than standard methods of investing. This can only be determined by examining the methods or examining the results.

I feel the most objective test as to just how conservative our manner of investing is arises through evaluation of performance in down markets. Preferably these should involve a substantial decline in the Dow. Our performance in the rather mild declines of 1957 and 1960 would confirm my hypothesis that we invest in an extremely conservative manner. I would welcome any partner's suggesting objective tests as to conservatism to see how we stack up. We have never suffered a realized loss of more than 0.5% of 1% of total net assets, and our ratio of total dollars of realized gains to total realized losses is something like 100 to 1. Of course; this reflects the fact that on balance we have been operating in an up market. However, there have been many opportunities for loss transactions even in markets such as these (you may have found out about a few of these yourselves) so I think the above facts have some significance.

The Question of Size

Aside from the question as to what happens upon my death (which with a metaphysical twist, is a subject of keen interest to me), I am probably asked most often: "What affect is the rapid growth of partnership funds going to have upon performance?"

Larger funds tug in two directions. From the standpoint of "passive" investments, where we do not attempt by the size of our investment to influence corporate policies, larger sums hurt results. For the mutual fund or trust department investing in securities with very broad markets, the effect of large sums should be to penalize results only very slightly. Buying 10,000 shares of General Motors is only slightly more costly (on the basis of mathematical expectancy) than buying 1,000 or 100 shares.

In some of the securities in which we deal (but not all by any means) buying 10,000 shares is much more difficult than buying 100 and is sometimes impossible. Therefore, for a portion of our portfolio, larger sums are definitely disadvantageous. For a larger portion of the portfolio, I would say increased sums are only slightly disadvantageous. This category includes most of our work-outs and some generals.

However, in the case of control situations increased funds are a definite advantage. A "Sanborn Map" cannot be accomplished without the wherewithal. My definite belief is that the opportunities increase in this field as the funds increase. This is due to the sharp fall-off in competition as the ante mounts plus the important positive correlation that exists between increased size of company and lack of concentrated ownership of that company's stock.

Which is more important -- the decreasing prospects of profitability in passive investments or the increasing prospects in control investments? I can't give a definite answer to this since to a great extent it depends on the type of market in which we are operating. My present opinion is that there is no reason to think these should not be offsetting factors; if my opinion should change, you will be told. I can say, most assuredly, that our results in 1960 and 1961 would not have been better if we had been operating with the much smaller sums of 1956 and 1957.

And a Prediction

Regular readers (I may be flattering myself) will feel I have left the tracks when I start talking about predictions. This is one thing from which I have always shied away and I still do in the normal sense.

I am certainly not going to predict what general business or the stock market are going to do in the next year or two since I don't have the faintest idea.

I think you can be quite sure that over the next ten years there are going to be a few years when the general market is plus 20% or 25%, a few when it is minus on the same order, and a majority when it is in between. I haven't any notion as to the sequence in which these will occur, nor do I think it is of any great importance for the long-term investor.

Over any long period of years, I think it likely that the Dow will probably produce something like 5% to 7% per year compounded from a combination of dividends and market value gain. Despite the experience of recent years, anyone expecting substantially better than that from the general market probably faces disappointment.

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%. I have stressed this point in talking with partners and have watched them nod their heads with varying degrees of enthusiasm. It is most important to me that you fully understand my reasoning in this regard and agree with me not only in your cerebral regions, but also down in the pit of your stomach.

For the reasons outlined in my method of operation, our best years relative to the Dow are likely to be in declining or static markets. Therefore, the advantage we seek will probably come in sharply varying amounts. There are bound to be years when we are surpassed by the Dow, but if over a long period we can average ten percentage points per year better than it, I will feel the results have been satisfactory.

Specifically, if the market should be down 35% or 40% in a year (and I feel this has a high probability of occurring one year in the next ten--no one knows which one), we should be down only 15% or 20%. If it is more or less unchanged during the year, we would hope to be up about ten percentage points. If it is up 20% or more, we would struggle to be up as much. The consequence of performance such as this over a period of years would mean that if the Dow produces a 5% to 7% per year overall gain compounded, I would hope our results might be 15% to 17% per year.

The above expectations may sound somewhat rash, and there is no question but that they may appear very much so when viewed from the vantage point of 1965 or 1970. It may turn out that I am completely wrong. However, I feel the partners are certainly entitled to know what I am thinking in this regard even though the nature of the business is such as to introduce a high probability of error in such expectations. In anyone year, the variations may be quite substantial. This happened in 1961, but fortunately the variation was on the pleasant side. They won't all be!

Miscellaneous

We are now installed in an office at 810 Kiewit Plaza with a first-class secretary, Beth Henley, and an associate with considerable experience in my type of securities, Bill Scott. My father is sharing office space with us (he also shares the expenses) and doing a brokerage business in securities. None of our brokerage is done through him so we have no "vicuna coat" situation.
Overall, I expect our overhead, excluding interest on borrowings and Nebraska Intangibles Tax, to run less than 0.5 of 1% of net assets. We should get our money's worth from this expenditure, and you are most cordially invited to drop in and see how the money is being spent.

With over 90 partners and probably 40 or so securities, you can understand that it is quite a welcome relief to me to shake loose from some of the details.

We presently have partners residing in locations from California to Vermont, and net assets at the beginning of 1962 amounted to $ 7,178,500.00. Susie and I have an interest in the partnership amounting to $1,025,000.00, and other relatives of mine have a combined interest totaling $782,600.00. The minimum for new partners last year was $25,000, but I am giving some thought to increasing it this year.

Peat, Marwick, Mitchell & Company did an excellent job of expediting the audit, providing tax figures much earlier than in the past. They assure me this performance can be continued.

Let me hear from you regarding questions you may have on any aspects of this letter, your audit, status of your partnership interest, etc. that may puzzle you.

Cordially Warren E. Buffett.

APPENDIX

Partnerships Operating Throughout 1961

Partnership	1/1/61 Capital at Market	Overall Gain in 1961*	Percentage Gain
Buffett Associates	486,874.27	225,387.80	46.3%
Buffett Fund	351,839.29	159,696.93	45.4%
Dacee	235,480.31	116,504.47	49.5%
Emdee	140,005.24	67,387.28	48.1%
Glenoff	78,482.70	39,693.80	50.5%
Mo-Buff	325,844.71	149,163.71	45.8%
Underwood	582,256.82	251,951.26	43.3%
	2,200,783.34	1,009,785.25	45.9%

Partnerships Started in 1961

Partnership	Paid-in	Overall Gain in 1961	Percentage Gain
Ann Investments	100,100 (1-30-61)	35,367.93	35.3%
Buffett-TD	250,100 ($200,100 on 3-8-61, $50,000 on 5-31-61)	70,294.08	28.1%
Buffett-Holland	125,100 (5-17-61)	16,703.76	13.3%

* Gain in net assets at market values plus payments to limited partners during year.

BUFFETT PARTNERSHIP, LTD.
810 KIEWIT PLAZA
OMAHA 31, NEBRASKA

July 6, 1962

A Reminder:

In my letter of January 24, 1962 reporting on 1961, I inserted a section entitled. "And a Prediction." While I have no desire to inflict cruel and unusual punishment upon my readers, nevertheless, a reprinting of that section, in its entirety, may be worthwhile:

And a Prediction

Regular readers (I may be flattering myself) will feel I have left the tracks when I start talking about predictions. This is one thing from which I have always shied away and I still do in the normal sense.

I am certainly not going to predict what general business or the stock market are going to do in the next year or two since I don't have the faintest idea.

I think you can be quite sure that over the next ten years there are going to be a few years when the general market is plus 20% or 25%, a few when it is minus on the same order, and a majority when it is in between. I haven't any notion as to the sequence in which these will occur, nor do I think it is of any great importance for the long-term investor.

Over any long period of years, I think it likely that the Dow will probably produce something like 5% to 7% per year compounded from a combination of dividends and market value gain. Despite the experience of recent years, anyone expecting substantially better than that from the general market probably faces disappointment.

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%. I have stressed this point in talking with partners and have watched them nod their heads with varying degrees of enthusiasm.

It is most important to me that you fully understand my reasoning in this regard and agree with me not only in your cerebral regions, but also down in the pit of your stomach.

For the reasons outlined in my method of operation, our best years relative to the Dow are likely to be in declining or static markets. Therefore, the advantage we seek will probably come in sharply varying amounts. There are bound to be years when we are surpassed by the Dow, but if over a long period we can average ten percentage points per year better than it, I will feel the results have been satisfactory.

Specifically, if the market should be down 35% or 40% in a year (and I feel this has a high probability of occurring one year in the next ten--no one knows which one), we should be down only 15% or 20%. If it is more or less unchanged during the year, we would hope to be up about ten percentage points. If it is up 20% or more, we would struggle to be up as much. The consequence of performance such as this over a period of years would mean that if the Dow produces a 5% to 7% per year over-all gain compounded, I would hope our results might be 15% to 17% per year.

> The above expectations may sound somewhat rash, and there is no question but that they may appear very much so when viewed from the vantage point of 1965 or 1970. It may turn out that I am completely wrong. However, I feel the partners are certainly entitled to know what I am thinking in this regard even though the nature of the business is such as to introduce a high probability of error in such expectations. In anyone year, the variations may be quite substantial. This happened in 1961, but fortunately the variation was on the pleasant side. They won't all be!

<u>The First Half of 1962:</u>

Between yearend 1961 and June 30, 1962 the Dow declined from 731.14 to 561.28. If one had owned the Dow during this period, dividends of approximately $11.00 would have been received so that overall a loss of 21.7% would have been the result of investing in the Dow. For the statistical minded, Appendix A gives the results of the Dow by years since formation of the predecessor partnerships.

As stated above, a declining Dow gives us our chance to shine and pile up the percentage advantages which, coupled with only an average performance during advancing markets, will give us quite satisfactory long-term results. Our target is an approximately 1/2% decline for each 1% decline in the Dow and if achieved, means we have a considerably more conservative vehicle for investment in stocks than practically any alternative.

As outlined in Appendix B, showing combined predecessor partnership results, during the first half of 1962 we had one of the best periods in our history, achieving a minus 7.5% result before payments to partners, compared to the minus 21.7% overall result on the Dow. This 14.2 percentage points advantage can be expected to widen during the second half if the decline in the general market continues, but will probably narrow should the market turn upward. Please keep in mind my continuing admonition that six-months' or even one-year's results are not to be taken too seriously. Short periods of measurement exaggerate chance fluctuations in performance. While circumstances contributed to an unusually good first half, there are bound to be periods when we do relatively poorly. The figures for our performance involve no change in the valuation of our controlling interest in Dempster Mill Manufacturing Company, although developments in recent months point toward a probable higher realization.

<u>Investment Companies during the First Half:</u>

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 are much more likely to be toward a poorer performance than a superior one.

To illustrate this point, we have continually measured the Dow and limited partners' results against the two largest open-end investment companies (mutual funds) following a program of common stock investment and the two largest closed-end investment companies. The tabulation in Appendix C shows the five -years' results, and you will note the figures are extraordinarily close to those of the Dow. These companies have total assets of about $3.5 billion.

In the interest of getting this letter out promptly, we are mailing it before results are available for the closed-end companies. However, the two mutual funds both did poorer than the Dow, with Massachusetts Investors Trust having a minus 23% overall performance, and Investors Stock Fund realizing a minus 25.4%. This is not unusual as witness the lead article in the WALL STREET JOURNAL of June 13, 1962 headed "Funds vs. Market." Of the 17 large common stock funds studied, everyone had a record poorer than the Dow from the peak on the Dow of 734, to the date of the article, although in some cases the margin of inferiority was minor.

Particularly hard hit in the first half were the so-called “growth” funds which, almost without exception, were down considerably more than the Dow. The three large "growth" (the quotation marks are more applicable now) funds with the best record in the preceding few years, Fidelity Capital Fund, Putnam Growth Fund, and Wellington Equity Fund averaged an overall minus 32.3% for the first half. It is only fair to point out that because of their excellent records in 1959-61, their overall performance to date is still better than average, as it may well be in the future. Ironically, however, this earlier superior performance had caused such a rush of new investors to come to them that the poor performance this year was experienced by very many more holders than enjoyed the excellent performance of earlier years. This experience tends to confirm my hypothesis that investment performance must be judged over a period of time with such a period including both advancing and declining markets. There will continue to be both; a point perhaps better understood now than six months ago.

In outlining the results of investment companies, I do so not because we operate in a manner comparable to them or because our investments are similar to theirs. It is done because such funds represent a public batting average of professional, highly-paid investment management handling a very significant $20 billion of securities. Such management, I believe, is typical of management handling even larger sums. As an alternative to an interest in the partnership, I believe it reasonable to assume that many partners would have investments managed similarly.

Asset Values:

The above calculations of results are before allocation to the General Partner and monthly payments to partners. Of course, whenever the overall results for the year are not plus 6% on a market value basis (with deficiencies carried forward) there is no allocation to the General Partner. Therefore, non-withdrawing partners have had a decrease in their market value equity during the first six months of 7.5% and partners who have withdrawn at the rate of 6% per annum have had a decrease in their market value equity during the first half of 10.5%. Should our results for the year be less than plus 6% (and unless there should be a material advance in the Dow, this is very probable) partners receiving monthly payments will have a decrease in their market value equity at December 31, 1962. This means that monthly payments at 6% on this new market equity next year will be on a proportionately reduced basis. For example, if our results were an overall minus 7% for the year, a partner receiving monthly payments who had a market value interest of $100,000 on January 1, 1962 would have an equity at December 31, 1962 of $87,000. This reduction would arise from the minus 7% result, or $7, 000 plus monthly payments of $500 for an additional $6,000. Thus, with $87,000 of market equity on January 1, 1963, monthly payments next year would be $435.00.

None of the above, of course, has any applicability to advance payments received during 1962 which do not participate in profits or losses, but earn a straight 6%.

APPENDIX A

DOW-JONES INDUSTRIAL AVERAGE

Year	Closing Dow	Change for Year	Dow Dividend	Overall Result from Dow	Percentage Result
1956	499.47	--	--	--	--
1957	435.69	-63.78	21.61	-42.17	-8.4%
1958	583.65	147.96	20.00	167.96	38.5%
1959	679.36	95.71	20.74	116.45	20.0%
1960	615.89	63.47	21.36	42.11	-6.2%
1961	731.14	115.25	22.61	137.86	22.4%
6/30/62	561.28	169.86	11.00 Est.	-158.86	-21.7%

APPENDIX B

PARTNERSHIP PERFORMANCE

Year	Partnership Result (1)	Limited Partners' Results (2)
1957	10.4%	9.3%
1958	40.9%	32.2%
1959	25.9%	20.9%
1960	22.8%	18.6%
1961	45.9%	35.9%
6/30/62	-7.5%	-7.5%

(1) For 1957-61 consists of combined results of all predecessor limited partnerships operating throughout entire year after all expenses but before distributions to partners or allocations to the general partners.

(2) For 1957-61 computed on basis of preceding column of partnership results allowing for allocation to general partner based upon present partnership agreement.

APPENDIX C

YEARLY RESULTS

Year	Mass. Inv. Trust (1)	Investors Stock (1)	Lehman (2)	Tri-Cont. (2)
1957	-11.4%	-12.4%	-11.4%	-2.4%
1958	42.7%	47.5%	40.8%	33.2%
1959	9.0%	10.3%	8.1%	8.4%
1960	-1.0%	-0.6%	2.5%	2.8%
1961	25.6%	24.9%	23.6%	22.5%
6/30/92	23.0%	-25.4%	N.A.	N.A.

(1) Computed from changes in asset value plus any distributions to holders of record during year.

(2) From Moody's Bank & Finance Manual - 1962.

CUMULATIVE RESULTS

Years	Mass. Inv. Trust	Investors Stock	Lehman	Tri-Cont.	Dow	Limited Partners
1957	-11.4%	-12.4%	-11.4%	-2.4%	-8.4%	9.3%
1957-58	26.4%	29.2%	24.7%	30.0%	26.9%	44.5%
1957-59	37.8%	42.5%	34.8%	40.9%	52.3%	74.7%
1957-60	36.4%	41.6%	38.2%	44.8%	42.9%	107.2
1957-61	71.4%	76.9%	70.8%	77.4%	74.9%	181.6
1957-6/30/62	31.9%	32.0%	N.A.	N.A.	37.0%	160.5%

BUFFETT PARTNERSHIP, LTD.
810 KIEWIT PLAZA
OMAHA 31, NEBRASKA

November 1, 1962

TO MY PARTNERS FOR 1963:

Here we go on the annual paper flurry. Two copies of an amended partnership agreement for 1963 are enclosed. The one with the General Provisions attached is to be kept by you and the other single-page agreement should be returned. There are no substantive changes of any sort from last year's agreement. This amendment is merely to allow for a few new partners and in several places to reword in clearer (we hope) language provisions of the present agreement. Practically all of the rewording is in General Provision 5 (paragraph 7 in last year's agreement). Rather than have a separate amending document, we have incorporated the changes into one complete document embodying the entire agreement.

We are also enclosing two commitment letters (one for you--one to be returned) on which you are to indicate your wishes regarding additions or withdrawals at January 1st. We would like to have the agreement and the commitment letter back by December 1st. However, the commitment letter can be amended right up until the end of the year (not after) so if you should have a change of plans and you have already mailed us your commitment letter, all you have to do is get in touch with me, and I will make whatever changes you desire.

Any withdrawals will be paid immediately after January 1st. Any additions must reach us by January 10th, and should they be paid in during November, they will take on the status of advance payments and draw interest at the rate of 6% until yearend.

Please be sure the signature on your partnership agreement is notarized. Partners in Omaha may obtain the notarization at our office if they wish. Also, be sure to let us know by an appropriate circle on the commitment letter whether you wish to receive monthly payments in 1963. In order to be sure everyone understands this, let me again state that these monthly payments are in no sense guaranteed earnings or anything of the sort. They represent a convenient form of regular withdrawal, which to the extent we earn better than 6% are payments from earnings, and to the extent we don't, are payments from capital.

Complete tax information for your 1962 return will be in your hands by January 20th. If you should need an estimate of your tax position before that time, let me know and I will give you a rough idea. We will also send out a short letter on taxes in late December.

Having read this far, you are entitled to a report on how we have done to date in 1962. For the period ending October 31st, the Dow-Jones Industrials showed an overall loss, including dividends received, of approximately 16.8%. We intend to use the same method or valuing our controlling interest in Dempster Mill Manufacturing at this yearend that we did at the end of last year. This involved applying various discounts to the balance sheet items to reflect my opinion as to what could be realized on a very prompt sale. Last year this involved a 40% discount on inventories, a 15% discount on receivables, estimated auction value of fixed assets, etc., which led to an approximate value or $35.00 per share.

The successful conversion of substantial portions of the assets of Dempster to cash, at virtually 100 cents on the dollar, has been the high point of 1962. For example, inventory of $4.2 million at last yearend will probably be about $1.9 million this yearend, reducing the discount on this item by about $920,000 (40% of $2.3 million reduction). I will give this story my full journalistic treatment in my annual letter. Suffice to say at this point that applying the same discounts described above will probably result in a yearend value of at least $50.00 per share. The extent of the asset conversion job can perhaps best be illustrated in a sentence by pointing out that whereas we had $166,000 of cash and $2,315,000 of liabilities at November 30, 1961 (Dempster fiscal yearend), we expect this year to have about $1 million in cash and investments (of the type the Partnership buys) against total liabilities of $250,000. Prospects for further improvement in this situation in 1963 appear good, and we expect a substantially expanded investment portfolio in Dempster next year.

Valuing Dempster at $50 per share, our overall gain (before any payments to partners) to October 31st for the Partnership has been 5.5%. This 22.3 percentage-points advantage over the Dow, if maintained until the end of the year, will be among the largest we have ever had. About 60% of this advantage was accomplished by the portfolio other than Dempster, and 40% was the result of increased value at Dempster.

I want all partners and prospective partners to realize the results described above are distinctly abnormal and will recur infrequently, if at all. This performance is mainly the result of having a large portion of our money in controlled assets and workout situations rather than general market situations at a time when the Dow declined substantially. If the Dow had advanced materially in 1962, we could have looked very bad on a relative basis, and our success to date in 1962 certainly does not reflect any ability on my part to guess the market (I never try), but merely reflects the fact that the high prices of generals partially forced me into other categories or investment. If the Dow had continued to soar, we would have been low man on the totem pole. We fully expect to have years when our method of operation will not even match the results of the Dow, although obviously I don't expect this on any long-term basis or I would throw in the towel and buy the Dow.

I'll cut this sermon short with the conclusion that I certainly do not want anyone to think that the pattern of the last few years is likely to be repeated; I expect future performance to reflect much smaller advantages on average over the Dow.

Each letter ends with the request that you let me know about anything that isn't clear. Please be sure that you do this. We are all geared up with secretarial help, a new typewriter, etc., and we want to be sure that this letter and agreement are understood by all.

Cordially,
Warren E. Buffett

WEB:bf
P/S: There are no prizes for being the last ones to get in the agreement and commitment letter, so please get to it as soon as possible. Remember the commitment letter can be amended by a postcard or a phone call--we are just trying to get the bulk of the work out of the way well before December 31st so we can concentrate on getting the audit, tax information, etc., out pronto at yearend.

BUFFETT PARTNERSHIP, LTD.
810 KIEWIT PLAZA
OMAHA 31, NEBRASKA

January 18, 1963

The Ground Rules

Some partners have confessed (that's the proper word) that they sometimes find it difficult to wade through my entire annual letter. Since I seem to be getting more long-winded each year, I have decided to emphasize certain axioms on the first pages. Everyone should be entirely clear on these points. To most of you this material will seem unduly repetitious, but I would rather have nine partners out of ten mildly bored than have one out of ten with any basic misconceptions.

1. In no sense is any rate of return guaranteed to partners. Partners who withdraw one-half of 1% monthly are doing just that--withdrawing. If we earn more than 6% per annum over a period of years, the withdrawals will be covered by earnings and the principal will increase. If we don't earn 6%, the monthly payments are partially or wholly a return of capital.

2. Any year in which we fail to achieve at least a plus 6% performance will be followed by a year when partners receiving monthly payments will find those payments lowered.

3. Whenever we talk of yearly gains or losses, we are talking about market values; that is, how we stand with assets valued at market at yearend against how we stood on the same basis at the beginning of the year. This may bear very little relationship to the realized results for tax purposes in a given year.

4. Whether we do a good job or a poor job is not to be measured by whether we are plus or minus for the year. It is instead to be measured against the general experience in securities as measured by the Dow-Jones Industrial Average, leading investment companies, etc. If our record is better than that of these yardsticks, we consider it a good year whether we are plus or minus. If we do poorer, we deserve the tomatoes.

5. While I much prefer a five-year test, I feel three years is an absolute minimum for judging performance. It is a certainty that we will have years when the partnership performance is poorer, perhaps substantially so, than the Dow. If any three-year or longer period produces poor results, we all should start looking around for other places to have our money. An exception to the latter statement would be three years covering a speculative explosion in a bull market.

6. I am not in the business of predicting general stock market or business fluctuations. If you think I can do this, or think it is essential to an investment program, you should not be in the partnership.

7. I cannot promise results to partners. What I can and do promise is that:

   a. Our investments will be chosen on the basis of value, not popularity;

   b. That we will attempt to bring risk of permanent capital loss (not short-term quotational loss) to an absolute minimum by obtaining a wide margin of safety in each commitment and a diversity of commitments; and

   c. My wife, children and I will have virtually our entire net worth invested in the partnership.

Our Performance in 1962

I have consistently told partners that we expect to shine on a relative basis during minus years for the Dow, whereas plus years of any magnitude may find us blushing. This held true in 1962.

Because of a strong rally in the last few months, the general market as measured by the Dow really did not have such a frightening decline as many might think. From 731 at the beginning of the year, it dipped to 535 in June, but closed at 652. At the end of 1960, the Dow stood at 616, so you can see that while there has been a good deal of action the past few years, the investing public as a whole is not too far from where it was in 1959 or 1960. If one had owned the Dow last year (and I imagine there are a few people playing the high flyers of 1961 who wish they had), they would have had a shrinkage in market value of 79.04 or 10.8%. However, dividends of approximately 23.30 would have been received to bring the overall results from the Dow for the year to minus 7.6%. Our own overall record was plus 13.9%. Below we show the year-by-year performance of the Dow, the partnership before allocation to the general partner, and the limited partners' results for all full years of Buffett Partnership, Ltd.'s and predecessor partnerships' activities:

Year	**Overall Results from Dow**	**Partnership Results (1)**	**Limited Partners Results (2)**
1957	-8.4%	10.4%	9.3%
1958	38.5%	40.9%	32.2%
1959	20.0%	25.9%	20.9%
1960	-6.2%	22.8%	18.6%
1961	22.4%	45.9%	35.9%
1962	-7.6%	13.9%	11.9%

(1) For 1957-61 consists of combined results of all predecessor limited partnerships operating throughout entire year after all expenses but before distributions to partners or allocations to the general partner.
(2) For 1957-61 computed on basis of preceding column of partnership results allowing for allocation to general partner based upon present partnership agreement.

The following table shows the cumulative or compounded results in the same three categories, as well as the average annual compounded rate:

Year	**Overall Results from Dow**	**Partnership Results**	**Limited Partners Results**
1957	-8.4%	10.4%	9.3%
1957-58	26.9%	55.6%	44.5%
1957-59	52.3%	95.9%	74.7%
1957-60	42.9%	140.6%	107.2%
1957-61	74.9%	251.0%	181.6%
1957-62	61.6%	299.8%	215.1%
Annual Compounded Rate	8.3%	26.0%	21.1%

My (unscientific) opinion is that a margin of ten percentage points per annum over the Dow is the very maximum that can be achieved with invested funds over any long period of years, so it may be well to mentally modify some of the above figures.

Partners have sometimes expressed concern as to the effect of size upon performance. This subject was reflected upon in last year's annual letter. The conclusion reached was that there were some situations where larger sums helped and some where they hindered, but on balance, I did not feel they would penalize performance. I promised to inform partners if my conclusions on this should change. At the beginning of 1957, combined limited partnership assets totaled $303,726 and grew to $7,178,500 at the beginning or 1962. To date, anyway, our margin over the Dow has indicated no tendency to narrow as funds increase.

Investment Companies

Along with the results of the Dow, we have regularly included the tabulations on the two largest open-end investment companies (mutual funds) following a common stock policy, and the two largest diversified closed-end investment companies. These four companies, Massachusetts Investors Trust, Investors Stock Fund, Tri-Continental Corp. and Lehman Corp. manage over $3 billion and are probably typical of most of the $20 billion investment company industry. My opinion is that their results parallel those of most bank trust departments and investment counseling organizations which handle, in aggregate, vastly greater sums.

The purpose of this tabulation, which is shown below, is to illustrate that the Dow is no pushover as an index of investment achievement. The advisory talent managing just the four companies shown commands annual fees of approximately $7 million and this represents a very small fraction of the industry. Nevertheless, the public batting average of this highly-paid talent indicates results slightly less favorable than the Dow. In no sense is this statement intended as criticism. Within their institutional framework and handling the many billions of dollars involved, I consider such average results virtually the only possible ones. Their merits lie in other than superior results.

Both our portfolio and method of operation differ substantially from the companies mentioned above. However, most partners, as an alternative to their interest in the partnership would probably have their funds invested in media producing results comparable with investment companies, and I, therefore feel they offer a meaningful test of performance.

Year	**Mass. Inv. Trust (1)**	**Investors Stock (1)**	**Lehman (2)**	**Tri-Cont. (2)**	**Dow**	**Limited Partners**
1957	-11.4%	-12.4%	-11.4%	-2.4%	-8.4%	9.3%
1958	42.7%	47.5%	40.8%	33.2%	38.5%	32.2%
1959	9.0%	10.3%	8.1%	8.4%	20.0%	20.9%
1960	-1.0%	-0.6%	2.5%	2.8%	-6.2%	18.6%
1961	25.6%	24.9%	23.6%	22.5%	22.4%	35.9%
1962	-9.8%	-13.4%	-13.0%	-10.0%	-7.6%	11.9%

(1) Computed from changes in asset value plus any distributions to holders of record during year.

(2) From 1962 Moody's Bank & Finance Manual for 1957-61. Estimated for 1962.

COMPOUNDED

Year	**Mass. Inv. Trust**	**Investor Stock**	**Lehman**	**Tri-Cont.**	**Dow**	**Limited Partners**
1957	-11.4%	-12.4%	-11.4%	-2.4%	-8.4%	9.3%
1957-58	26.4%	29.2%	24.7%	30.0%	26.9%	44.5%
1957-59	37.8%	42.5%	34.8%	40.9%	52.3%	74.7%
1957-60	36.4%	41.6%	38.2%	44.8%	42.9%	107.2%
1957-61	71.3%	76.9%	70.8%	77.4%	74.9%	181.6%
1957-62	54.5%	53.2%	48.6%	59.7%	61.6%	215.1%

Annual Compounded Rate	7.5%	7.4%	6.8%	8.1%	8.3%	21.1%

The Joys of Compounding

I have it from unreliable sources that the cost of the voyage Isabella originally underwrote for Columbus was approximately $30,000. This has been considered at least a moderately successful utilization of venture capital. Without attempting to evaluate the psychic income derived from finding a new hemisphere, it must be pointed out that even had squatter's rights prevailed, the whole deal was not exactly another IBM. Figured very roughly, the $30,000 invested at 4% compounded annually would have amounted to something like $2,000,000,000,000 (that's $2 trillion for those of you who are not government statisticians) by 1962. Historical apologists for the Indians of Manhattan may find refuge in similar calculations. Such fanciful geometric progressions illustrate the value of either living a long time, or compounding your money at a decent rate. I have nothing particularly helpful to say on the former point.

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

Our Method of Operation

Our avenues of investment break down into three categories. These categories have different behavior characteristics, and the way our money is divided among them will have an important effect on our results, relative to the Dow, in any given year. The actual percentage division among categories is to some degree planned, but to a great extent, accidental, based upon availability factors.

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.

Sometimes these work out very fast; many times they take years. It is difficult at the time of purchase to know any compelling reason why they should appreciate in price. However, because of this lack of glamour or anything pending which might create immediate favorable market action, they are available at very cheap prices. A lot of value can be obtained for the price paid. This substantial excess of value creates a comfortable margin of safety in each transaction. Combining this individual margin of safety with a diversity of commitments creates a most attractive package of safety and appreciation potential. 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.

Many times generals represent a form of "coattail riding" where we feel the dominating stockholder group has plans for the conversion of unprofitable or under-utilized assets to a better use. We have done that ourselves in Sanborn and Dempster, but everything else equal we would rather let others do the work. Obviously, not only do the values have to be ample in a case like this, but we also have to be careful whose coat we are holding.

The generals tend to behave market-wise very much in sympathy with the Dow. Just because something is cheap does not mean it is not going to go down. During abrupt downward movements in the market, this segment may very well go down percentage-wise just as much as the Dow. Over a period of years, I believe the generals will outperform the Dow, and during sharply advancing years like 1961. This is the section of our portfolio that turns in the best results. It is, of course, also the most vulnerable in a declining market, and in 1962, not only did we not make any money out of our general category, but I am even doubtful if it did better than the Dow.

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 applecart. Corporate events such as mergers, liquidations, reorganizations, spin-offs, etc., I lead to work-outs. An important source in recent years has been sell-outs by oil producers to major integrated oil companies.

This category will produce reasonably stable earnings from year to year, to a large extent irrespective of the course of the Dow. Obviously, if we operate throughout a year with a large portion of our portfolio in work-outs, we will look extremely good if it turns out to be a declining year for the Dow, or quite bad if it is a strongly advancing year.

We were fortunate in that we had a good portion of our portfolio in work outs in 1962. As I have said before, this was not due to any notion on my part as to what the market would do, but rather because I could get more of what I wanted in this category than in the generals. This same concentration in work-outs hurt our performance during the market advance in the second half of the year.

Over the years, work-outs have provided our second largest category. At any given time, we may be in five to ten 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. For instance, you will note when you receive our audit report, that we paid $75,000 of interest to banks and brokers during the year. Since our borrowing was at approximately 5%, this means we had an average of $1,500,000 borrowed from such sources. Since 1962 was a down year in the market, you might think that such borrowing would hurt results. However, all of our loans were to offset work-outs, and this category turned in a good profit for the year. Results, excluding the benefits derived from the use of borrowed money, usually fall in the 10% to 20% per annum range. My self-imposed standard limit regarding borrowing is 25% of partnership net worth, although something extraordinary could result in modifying this for a limited period of time.

You will note on our yearend balance sheet (part of the audit you will receive) securities sold short totaling some $340,000. Most of this occurred in conjunction with a work-out entered into late in the year. In this case, we had very little competition for a period of time and were able to create a 10% or better profit (gross, not annualized) for a few months tie-up of money. The short sales eliminated the general market risk.

The final category is I “control” situations, where we either control the company or take a very large position and attempt to influence policies of the company. Such operations should definitely be measured on the basis of several years. In a given year, they may produce nothing as it is usually to our advantage to have the stock be stagnant market-wise for a long period while we are acquiring it. These situations, too, have relatively little in common with the behavior of the Dow. Sometimes, of course, we buy into a general with the thought in mind that it might develop into a control situation. If the price remains low enough for a long period, this might very well happen. Usually, it moves up before we have a substantial percentage of the company's stock, and we sell at higher levels and complete a successful general operation.

Dempster Mill Manufacturing Company

The high point of 1962 from a performance standpoint was our present control situation --73% owned Dempster Mill. Dempster has been primarily in farm implements (mostly items retailing for $1,000 or under), water systems, water well supplies and jobbed plumbing lines.

The operations for the past decade have been characterized by static sales, low inventory turnover and virtually no profits in relation to invested capital.

We obtained control in August, 1961 at an average price of about $28 per share, having bought some stock as low as $16 in earlier years, but the vast majority in an offer of $30.25 in August. When control of a company is obtained, obviously what then becomes all-important is the value of assets, not the market quotation for a piece of paper (stock certificate).

Last year, our Dempster holding was valued by applying what I felt were appropriate discounts to the various assets. These valuations were based on their status as non-earning assets and were not assessed on the basis of potential, but on the basis of what I thought a prompt sale would produce at that date. Our job was to compound these values at a decent rate. The consolidated balance sheet last year and the calculation of fair value are shown below.

(000's omitted)

Assets	Book Figure	Valued @	Adjusted Valuation	Liabilities	
Cash	$166	100%	$166	Notes Payable	$1,230
Accts. Rec. (net)	$1,040	85%	$884	Other Liabilities	$1,088
Inventory	$4,203	60%	$2,522		
Ppd. Exp. Etc.	$82	25%	$21		
Current Assets	$5,491		$3,593	Total Liabilities	$2,318
Cash Value Life ins., etc.	$45	100 Est. net auction value	$45	Net Work per Books:	$4,601
Net Plant Equipment	$1383		$800	Net Work as Adjusted to Quickly Realizable Values	$2,120
Total Assets	$6,919		$4,438	Shares outstanding 60,146 Adj. Value per Share	$35.25

Dempster's fiscal year ends November 30th, and because the audit was unavailable in complete form, I approximated some of the figures and rounded to $35 per share last year.

Initially, we worked with the old management toward more effective utilization of capital, better operating margins, reduction of overhead, etc. These efforts were completely fruitless. After spinning our wheels for about six months, it became obvious that while lip service was being given to our objective, either through inability or unwillingness, nothing was being accomplished. A change was necessary.

A good friend, whose inclination is not toward enthusiastic descriptions, highly recommended Harry Bottle for our type of problem. On April 17, 1962 I met Harry in Los Angeles, presented a deal which provided for rewards to him based upon our objectives being met, and on April 23rd he was sitting in the president's chair in Beatrice.

Harry is unquestionably the man of the year. Every goal we have set for Harry has been met, and all the surprises have been on the pleasant side. He has accomplished one thing after another that has been labeled as impossible, and has always taken the tough things first. Our breakeven point has been cut virtually in half, slow-moving or dead merchandise has been sold or written off, marketing procedures have been revamped, and unprofitable facilities have been sold.

The results of this program are partially shown in the balance sheet below, which, since it still represents non-earning assets, is valued on the same basis as last year.

(000's omitted)

Assets	**Book Figure**	**Valued @**	**Adjusted Valuation**	**Liabilities**	
Cash	$60	100%	$60	Notes payable	$0
Marketable securities	$758	Mrkt. 12/31/62	$834	Other liabilities	<u>$346</u>
Accts. Rec. (net)	$796	85%	$676	Total liabilities	$346
Inventory	$1,634	60%	$981		
Cash value life ins.	$41	100%	$41	Net Worth:	
Recoverable Income Tax	$170	100%	$170	Per Books	$4,077
Ppd. Exp. Etc.	<u>$14</u>	25%	<u>$4</u>	As Adjusted to quickly realizable values	$3,125
				Add: proceeds from potential exercise of option to Harry Bottle	<u>$60</u>
Current Assets	$3,473		$2,766		
				Shares outstanding 60,146	
Misc. Invest.	$5	100%	$5	Add: shs. Potentially outstanding under option 2000	
				Total shs. 62,146	
Net Plant Equipment	<u>$945</u>	Est. net auction value	<u>$700</u>		
				Adjusted value per share	$51.26
Total Assets	$4,423		$3,471		

Three facts stand out: (1) Although net worth has been reduced somewhat by the housecleaning and writedowns ($550,000 was written out of inventory; fixed assets overall brought more than book value), we have converted assets to cash at a rate far superior to that implied in our year-earlier valuation. (2) To some extent, we have converted the assets from the manufacturing business (which has been a poor business) to a business which we think is a good business --securities. (3) By buying assets at a bargain price, we don't need to pull any rabbits out 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."

On January 2, 1963, Dempster received an unsecured term loan of $1,250,000. These funds, together with the funds all ready "freed-up" will enable us to have a security portfolio of about $35 per share at Dempster, or considerably more than we paid for the whole company. Thus our present valuation will involve a net of about $16 per share in the manufacturing operation and $35 in a security operation comparable to that of Buffett Partnership, Ltd.

We, of course, are devoted to compounding the $16 in manufacturing at an attractive rate and believe we have some good ideas as to how to accomplish this. While this will be easy if the business as presently conducted earns money, we have some promising ideas even if it shouldn't.

It should be pointed out that Dempster last year was 100% an asset conversion problem and therefore, completely unaffected by the stock market and tremendously affected by our success with the assets. In 1963, the manufacturing assets will still be important, but from a valuation standpoint it will behave considerably more like a general since we will have a large portion of its money invested in generals pretty much identical with those in Buffett Partnership, Ltd. For tax reasons, we will probably not put workouts in Dempster. Therefore, if the Dow should drop substantially, it would have a significant effect on the Dempster valuation. Likewise, Dempster would benefit this year from an advancing Dow which would not have been the case most of last year.

There is one final point of real significance for Buffett Partnership, Ltd. We now have a relationship with an operating man which could be of great benefit in future control situations. Harry had never thought of running an implement company six days before he took over. He is mobile, hardworking and carries out policies once they are set. He likes to get paid well for doing well, and I like dealing with someone who is not trying to figure how to get the fixtures in the executive washroom gold-plated.
Harry and I like each other, and his relationship with Buffett Partnership, Ltd. should be profitable for all of us.

<u>The Question of Conservatism</u>

Because I believe it may be even more meaningful after the events of 1962 I would like to repeat this section from last year’s letter:

"The above description of our various areas of operation may provide some clues as to how conservatively our portfolio is invested. Many people some years back thought they were behaving in the most conservative manner by purchasing medium or long-term municipal or government bonds. This policy has produced substantial market depreciation in many cases, and most certainly has failed to maintain or increase real buying power.

"Conscious, perhaps overly conscious, of inflation, many people now feel that they are behaving in a conservative manner by buying blue chip securities almost regardless of price-earnings ratios, dividend yields, etc. Without the benefit of hindsight as in the bond example, I feel this course of action is fraught with danger. There is nothing at all conservative, in my opinion, about speculating as to just how high a multiplier a greedy and capricious public will put on earnings.

You will not be right simply because a large number of people momentarily agree with you. You will not be right simply because important people agree with you. In many quarters the simultaneous occurrence of the two above factors is enough to make a course of action meet the test of conservatism.

“You will be right, over the course of many transactions, if your hypotheses are correct, your facts are correct, and your reasoning is correct. True conservatism is only possible through knowledge and reason.

I might add that in no way does the fact that our portfolio is not conventional prove that we are more conservative or less conservative than standard methods of investing. This can only be determined by examining the methods or examining the results.

I feel the most objective test as to just how conservative our manner of investing is arises through evaluation of performance in down markets. Preferably these should involve a substantial decline in the Dow. Our performance in the rather mild declines of 1957 and 1960 would confirm my hypothesis that we invest in an extremely conservative manner. I would welcome any partner's suggesting objective tests as to conservatism to see how we stack up. We have never suffered a realized loss of more than ½ of 1% of total net assets and our ratio of total dollars of realized gains to total realized losses is something like 100 to 1. Of course, this reflects the fact that on balance we have been operating in an up market. However there have been many opportunities for loss transactions even in markets such as these (you may have found out about a few of these yourselves) so I think the above facts have some significance.

In 1962, we did realize a loss on one commitment or 1.0% and our ratio or realized gains to losses was only slightly over 3 to 1. However, compared to more conventional (often termed conservative which is not synonymous) methods of common stock investing, it would appear that our method involved considerably less risk. Our advantage over the Dow was all achieved when the market was going down; we lost a bit of this edge on the way up.

<u>The Usual Prediction</u>

I am certainly not going to predict what general business or the stock market are going to do in the next year or two, since I don't have the faintest idea.

I think you can be quite sure that over the next ten years, there are going to be a few years when the general market is plus 20% or 25% a few when it is minus on the same order, and a majority when it is in between. I haven't any notion as to the sequence in which these will occur, nor do I think it is of any great importance for the long-term investor. If you will take the first table on page 3 and shuffle the years around, the compounded result will stay the same. If the next four years are going to involve, say, a +40%, -30%, +10% and –6%, the order in which they fall is completely unimportant for our purposes as long as we all are around at the end of the four years. Over a long period of years, I think it likely that the Dow will probably produce something like 5% per year compounded from a combination of dividends and market value gain. Despite the experience of the last decade, anyone expecting substantially better than that from the general market probably faces disappointment.

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%.

For the reasons outlined in our method of operation, our best years relative to the Dow are likely to be in declining or static markets. Therefore, the advantage we seek will probably come in sharply varying amounts. There are bound to be years when we are surpassed by the Dow, but if over a long period we can average ten percentage points per year better than it, I will feel the results have been satisfactory.

Specifically, if the market should be down 35% or 40% in a year (and I feel this has a high probability of occurring one year in the next ten --no one knows which one), we should be down only 15% or 20%. If it is more or less unchanged during the year, we would hope to be up about ten percentage points. If it is up 20% or more, we would struggle to be up as much. It is certainly doubtful we could match a 20% or 25% advance from the December 31, 1962 level. The consequence of performance such as this over a period of years would mean that if the Dow produces a 5% per year overall gain compounded, I would hope our results might be 15% per year.

The above expectations may sound somewhat rash, and there is no question but that they may appear very much so when viewed from the vantage point of 1965 or 1970. Variations in any given year from the behavior described above would be wide, even if the long-term expectation was correct. Certainly, you have to recognize the possibility of substantial personal bias in such hopes.

Miscellaneous

This year marked the transition from the office off the bedroom to one a bit (quite a bit) more conventional. Surprising as it may seem, the return to a time clock life has not been unpleasant. As a matter of fact, I enjoy not keeping track of everything on the backs of envelopes.

We are starting off this year with net assets of $9,405,400.00. At the start of 1962, Susie and I had three “non-marketable security” investments of other than nominal size, and two of these have been sold. The third will be continued indefinitely. From the proceeds of the two sales, we have added to our partnership interest so that we now have an interest of $1,377,400.00. Also, my three children, mother, father, two sisters, two brothers-in-law, father-in-law, three aunts, four cousins, five nieces and nephews have interests directly or indirectly totaling $893,600.00.

Bill Scott who has fit into our operation splendidly has an interest (with his wife) of $167,400.00; A very large portion of his net worth. So we are all eating our own cooking.

You will note from the auditor's certificate that they made a surprise check during the year and this will be a continuing part of their procedure. Peat, Marwick, Mitchell & Co. again did an excellent job on the audit, meeting our rather demanding time schedules.

Susie was in charge of equipping the office which means we did not follow my “orange crate" approach to interior decorating. We have an ample supply of Pepsi on hand and look forward to partners dropping in.

Beth Feehan continues to demonstrate why she is the high priestess of the CPS (certified professional secretary, that is) group.

Partners did a wonderful job of cooperating in the return of agreements and commitment letters, and I am most appreciative of this. It makes life a lot easier. Enclosed you will find Schedule “A” to your partnership agreement. You will be receiving your audit and tax figures very soon, and if you have questions on any of this be sure to let me hear from you.

Cordially,
Warren E. Buffett

BUFFETT PARTNERSHIP, LTD.
810 KIEWIT PLAZA
OMAHA 31, NEBRASKA

July 10, 1963

First Half Performance

During the first half of 1963, the Dow Jones Industrial Average (hereinafter called the "Dow") advanced from 652.10 to 706.88. If one had owned the Dow during this period, dividends of $10.66 would have been received, bringing the overall return from the Dow during the first half to plus 10.0%.

Our incantation has been: (1) that short-term results (less than three years) have little meaning, particularly in reference to an investment operation such as ours that devotes a portion of resources to control situations, and; (2) That our results relative to the Dow and other common-stock-form media, will be better in declining markets and may well have a difficult time just matching such media in bubbling markets.

Nevertheless, our first-half performance, excluding any change in Dempster valuation (and its valuation did change --I'm saving this for dessert later in the letter) was plus 14%. This 14% is computed on total net assets (not non-Dempster assets) and is after expenses, but before monthly payments (to those who take them) to partners and allocation to the General Partner. Such allocations are academic on an interim basis, but if we were also plus 14% at yearend, the first 6% would be allocated to partners according to their capital, plus three-quarters of the balance of 8% (14% -6%), or an additional 6%, giving the limited partners a plus 12% performance.

Despite the relatively pleasant results of the first half the admonitions stated two paragraphs earlier hold in full force. At plus 14% versus plus 10% for the Dow, this six months has been a less satisfactory period than the first half of 1962 when we were minus 7.5% versus minus 21.7% for the Dow. You should completely understand our thinking in this regard which has been emphasized in previous letters.

During the first half we had an average net investment in "generals" (long positions in generals minus short positions in generals) of approximately $5,275,000. Our overall gain from this net investment in generals (for a description of our investment categories see the last annual letter) was about $1,100,000 for a percentage gain from this category of roughly 21%. This again illustrates the extent to which the allocation of our resources among various categories affects short-term results. In 1962 the generals were down for the year and only an outstanding performance by both of the other two categories, "work-outs" and "controls," gave us our unusually favorable results for that year.

Now this year, our work-outs have done poorer than the Dow and have been a drag on performance, as they are expected to be in rising markets. While it would be very nice to be 100% in generals in advancing markets and 100% in work-outs in declining markets, I make no attempt to guess the course of the stock market in such a manner. We consider all three of our categories to be good businesses on a long-term basis, although their short-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.

Investment Companies

Shown below are the usual statistics on a cumulative basis for the Dow and Buffett Partnership. Ltd. (including predecessor partnerships) as well as for the two largest open-end (mutual funds) and two largest closed-end investment companies following a diversified common-stock investment policy:

Year	Dow	Mass.Inv. Trust (1)	Investors Stock (1)	Tri-Cont. (2)
1957	-8.4%	-11.4%	-12.4%	-2.4%
1957 – 58	26.9%	26.4%	29.2%	30.0%
1957 – 59	52.3%	37.8%	42.5%	40.9%
1957 – 60	42.9%	36.4%	41.6%	44.8%
1957 – 61	74.9%	71.3%	76.9%	77.4%
1957 – 62	61.6%	54.5%	53.2%	59.7%
1957 – 6/30/63	77.8%	72.4%	69.3%	75.7%
Annual Compounded Rate	9.3%	8.7%	8.4%	9.1%

Year	Lehman (2)	Partnership (3)	Limited Partners (4)
1957	-11.4%	10.4%	9.3%
1957 – 58	24.7%	55.6%	44.5%
1957 – 59	34.8%	95.9%	74.7%
1957 – 60	38.2%	140.6%	107.2%
1957 – 61	70.8%	251.0%	181.6%
1957 – 62	46.2%	299.8%	215.1%
1957 – 6/30/63	60.8%	355.8%	252.9%
Annual Compounded Rate	7.6%	26.3%	21.4%

Footnotes :

(1) Computed from changes in asset value plus any distributions to holders of record during year.

(2) From 1963 Moody's Bank & Finance Manual for 1957-62. Estimated for first half 1963.

(3) For 1957-61 consists of combined results of all predecessor limited partnerships operating throughout entire year after all expenses but before distributions to partners or allocations to the general partner.

(4) For 1957-61 computed on basis of preceding column of partnership results allowing for allocation to general partner based upon present partnership agreement.

The results continue to show that the most highly paid and respected investment advice has difficulty matching the performance of an unmanaged index of blue-chip stocks. This in no sense condemns these institutions or the investment advisers and trust departments whose methods, reasoning, and results largely parallel such investment companies. These media perform a substantial service to millions of investors in achieving adequate diversification, providing convenience and peace of mind, avoiding issues of inferior quality, etc. However, their services do not include (and in the great majority of cases, are not represented to include) the compounding of money at a rate greater than that achieved by the general market.

Our partnership's fundamental reason for existence is to compound funds at a better-than-average rate with less exposure to long-term loss of capital than the above investment media. We certainly cannot represent that we will achieve this goal. We can and do say that if we don't achieve this goal over any reasonable period excluding an extensive speculative boom, we will cease operation.

Dempster Mill Manufacturing Company

In our most recent annual letter, I described Harry Bottle as the "man of the year". If this was an understatement.

Last year Harry did an extraordinary job of converting unproductive assets into cash which we then, of course, began to invest in undervalued securities. Harry has continued this year to turn under-utilized assets into cash, but in addition, he has made the remaining needed assets productive. Thus we have had the following transformation in balance sheets during the last nineteen months:

November 30, 1961 (000's omitted)

Assets	**Book Figure**	**Valued @**	**Adjusted Valuation**	**Liabilities**	
Cash	$166	100%	$166	Notes Payable	$1,230
Accts. Rec. (net)	$1,040	85%	$884	Other Liabilities	$1,088
Inventory	$4,203	60%	$2,522		
Ppd. Exp. Etc.	$82	25%	$21	Total Liabilities	$2,318
Current Assets	$5,491		$3,593	Net Worth:	
				Per Books	$4,601
Cash Value Life ins., etc.	$45	100%	$45	As adjusted to quickly realizable values	$2,120
Net Plant & equipment	$1,383	Est. Net Auction Value	$800		
Total Assets	$6,919		$4,438	Share outstanding 60,146. Adj. Value per Share	$35.25

November 30, 1962 (000's omitted)

Assets	**Book Figure**	**Valued @**	**Adjusted Valuation**	**Liabilities**	
Cash	$60	100%	$60	Notes payable	$0
Marketable Securities	$758	Mkt. 12/31/62	$834	Other liabilities	$346
Accts. Rec. (net)	$796	85%	$676	Total liabilities	$346
Inventory	$1,634	60%	$981		
Cash value life ins.	$41	100%	$41	Net Worth:	
Recoverable income tax	$170	100%	$170	Per books	$4,077
Ppd. Exp. Etc	$14	25%	$4	As adjusted to quickly realizable values	$3,125
				Add: proceeds from potential exercise of option to Harry Bottle	$60
Current Assets	$3,473		$2,766		$3,185
				Shares Outstanding 60,146	
Misc. Invest.	$5	100%	$5	Add: shs. Potentially outstanding under option: 2,000	
				Total shs. 62,146	
Net plant & equipment	$945	Est. net auction value	$700	Adj. Value per Share	$51.26
Total Assets	$4,423		$3,471		

November 30, 1963 (000's omitted)

Assets	**Book Figure**	**Valued @**	**Adjusted Valuation**	**Liabilities**	
Cash	$144	100%	$144	Notes payable (paid 7/3/63)	$125
Marketable Securities	$1,772	Mkt. 6/30/63	$2,029	Other liabilities	$394
Accts. Rec. (net)	$1,262	85%	$1,073	Total Liabilities	$519
Inventory	$977	60%	$586		
Ppd. Exp. Etc	$12	25%	$3	Net Worth:	
				Per books	$4,582
Current Assets	$4,167		$3,835	As adjusted to quickly realizable values	$4,028
Misc. Invest	$62	100%	$62	Shares outstanding 62,146	
Net plant & equip.	$872	Est. net auction value	$650	Adj. Value per share	$64.81
Total assets	$5,101		$4,547		

I have included above the conversion factors we have previously used in valuing Dempster for B.P.L. purposes to reflect estimated immediate sale values of non-earning assets.

As can be seen, Harry has converted the assets at a much more favorable basis than was implied by my valuations. This largely reflects Harry's expertise and, perhaps, to a minor degree my own conservatism in valuation.

As can also be seen, Dempster earned a very satisfactory operating profit in the first half (as well as a substantial unrealized gain in securities) and there is little question that the operating business, as now conducted, has at least moderate earning power on the vastly reduced assets needed to conduct it. Because of a very important-seasonal factor and also the presence of a tax carry forward, however, the earning power is not nearly what might be inferred simply by a comparison of the 11/30/62 and 6/30/63 balance sheets. Partly because of this seasonality, but more importantly, because of possible developments in Dempster before 1963 yearend, we have left our Dempster holdings at the same $51.26 valuation used at yearend 1962 in our figures for B.P.L's first half. However, I would be very surprised if it does not work out higher than this figure at yearend.

One sidelight for the fundamentalists in our group: B.P.L. owns 71.7% of Dempster acquired at a cost of $1,262,577.27. On June 30, 1963 Dempster had a small safe deposit box at the Omaha National Bank containing securities worth $2,028,415.25. Our 71.7% share of $2,028,415.25 amounts to $1,454,373.70. Thus, everything 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.

Advance Payments and Advance Withdrawals

We accept advance payments from partners and prospective partners at 6% interest from date of receipt until the end of the year. While there is no obligation to convert the payment to a partnership interest at the end of the year, this should be the intent at the time of payment.

Similarly, we allow partners to withdraw up to 20% of their partnership account prior to yearend and charge them 6% from date of withdrawal until yearend when it is charged against their capital account. Again, it is not intended that partners use US like a bank, but that they use the withdrawal right for unanticipated need for funds.

The willingness to both borrow and lend at 6% may seem "un-Buffett-like.” We look at the withdrawal right as a means of giving some liquidity for unexpected needs and, as a practical matter, are reasonably sure it will be far more than covered by advance payments.

Why then the willingness to pay 6% for advance payment money when we can borrow from commercial banks at substantially lower rates? For example, in the first half we obtained a substantial six-month bank loan at 4%. The answer is that we expect on a long-term basis to earn better than 6% (the general partner's allocation is zero unless we do although it is largely a matter of chance whether we achieve the 6% figure in any short period. Moreover, I can adopt a different attitude in the investment of money that can be expected to soon be a part of our equity capital than I can on short-term borrowed money. The advance payments have the added advantage to us of spreading the investment of new money over the year, rather than having it hit us all at once in January. On the other hand, 6% is more than can be obtained in short-term dollar secure investments by our partners, so I consider it mutually profitable. On June 30, 1963 we had advance withdrawals of $21,832.00 and advance payments of $562,437.11.

Taxes

There is some possibility that we may have fairly substantial realized gains this year. Of course, this may not materialize at all and actually does not have anything to do with our investment performance this year. I am an outspoken advocate of paying large amounts of income taxes -- at low rates. A tremendous number of fuzzy, confused investment decisions are rationalized through so-called "tax considerations.”

My net worth is the market value of holdings less the tax payable upon sale. The liability is just as real as the asset unless the value of the asset declines (ouch), the asset is given away (no comment), or I die with it. The latter course of action would appear to at least border on a Pyrrhic victory.

Investment decisions should be made on the basis of the most probable compounding of after-tax net worth with minimum risk. Any isolation of low-basis securities merely freezes a portion of net worth at a compounding factor identical with the assets isolated. While this may work out either well or badly in individual cases, it is a nullification of investment management. The group experience holding various low basis securities will undoubtedly approximate group experience on securities as a whole, namely compounding at the compounding rate of the Dow. We do not consider this the optimum in after-tax compounding rates.

I have said before that if earnings from the partnership can potentially amount to a sizable portion of your total taxable income, the safe thing to do is to estimate this year the same tax you incurred last year. If you do this, you cannot run into penalties. In any event, tax liabilities for those who entered the partnership on 1/1/63 will be minimal because of the terms of our partnership agreement first allocating capital gains to those having an interest in unrealized appreciation.

As in past years, we will have a letter out about November 1st (to partners and those who have indicated an interest to me by that time in becoming partners) with the amendment to the partnership agreement, commitment letter for 1964, estimate of the 1963 tax situation, etc.

My closing plea for questions regarding anything not clear always draws a blank. Maybe no one reads this far. Anyway, the offer is still open.

Cordially,

Warren E. Buffett

BUFFETT PARTNERSHIP, LTD.
810 KIEWIT PLAZA
OMAHA 31, NEBRASKA

November 6, 1963

To My Partners for 1964:

Enclosed is the usual assortment of Thanksgiving reading material:

(1) Two copies of an amended partnership agreement for 1964. The one with the General Provisions attached is to be kept by you (exactly the same as last year) and the other single page agreement is to be signed, notarized and returned to us. Partners in Omaha may come in and obtain the notarization at our office.

(2) A copy of that priceless treatise, "The Ground Rules," I would like every partner to read this at least once a year, and it is going to be a regular item in my November package. Don't sign the partnership agreement unless you fully understand the concepts set forth and are in accord with them -- mentally and viscerally.

(3) Two copies of the commitment letter for 1964, one to be kept by you and one returned to us. You may amend this commitment letter right up to midnight, December 31st, so get it back to us early, and if it needs to be changed, just let us know by letter or phone.

Any withdrawals will be paid immediately after January 1st. You may withdraw any amount you desire from $100 up to your entire equity. Similarly, additions can be for any amount and should reach us by January 10th. In the event you are disposing of anything, this will give you a chance to have the transaction in 1964 if that appears to be advantageous for tax reasons. If additions reach us in November, they take on the status of advance payments and draw interest at the rate of 6% until yearend. This is not true of additions reaching us in December.

Complete tax information for your 1963 return will be in your hands by January 25th. If you should need an estimate of your tax position before that time, let me know and I will give you a rough idea. We will also send out a short letter on taxes in late December.

At the end of October, the overall result from the Dow for 1963 was plus 18.8%. We have had a good year in all three categories, generals, work-outs and controls. A satisfactory sale on a going concern basis of Dempster Mill Manufacturing operating assets was made about a month ago. I will give the full treatment to the Dempster story in the annual letter, perhaps climaxed by some lyrical burst such as "Ode to Harry Bottle." While we always had a built-in profit in Dempster because of our bargain purchase price, Harry accounted for several extra servings of dessert by his extraordinary job. Harry, incidentally, has made an advance payment toward becoming a limited partner in 1964-- we consider this the beginning, not the end.

However, 1963 has not been all Dempster. While a great deal can happen the last two months and therefore interim results should not be taken too seriously, at the end of October the overall gain for the partnership was about 32%. Based on the allocation embodied in our agreement, this works out to plus 25 1/2% for the limited partners before monthly payments to those who take them. Of our approximate $3 million gain, something over $2 million came from marketable securities and a little less than $1 million from Dempster operating assets. The combined gain from our single best general and best work-out situation approximated the gain on the Dempster operating assets.

You should be aware that if our final results relative to the Dow for 1963 are as favorable as on October 31st, I will regard it as an abnormal year. I do not consider a 13.2 percentage point margin to be in the cards on a long term basis. A considerably more moderate annual edge over the Dow will be quite satisfactory.

Cordially

Warren E. Buffett

P/S. Last year we announced there would be no prizes for the last ones to get the material back to us. This continues to be our policy. Save us some last minute scurrying by getting your agreement and commitment letter back pronto. Give Bill or me a call if we can be of any help. Thanks!

BUFFETT PARTNERSHIP, LTD.
810 KIEWIT PLAZA
OMAHA 31, NEBRASKA

January 18, 1964

Our Performance in 1963

1963 was a good year. It was not a good year because we had an overall gain of $3,637,167 or 38.7% on our beginning net assets, pleasant as that experience may be to the pragmatists in our group. Rather it was a good year because our performance was substantially better than that of our fundamental yardstick --the Dow-Jones Industrial Average (hereinafter called the “Dow”). If we had been down 20% and the Dow had been down 30%, this letter would still have begun “1963 was a good year.” Regardless of whether we are plus or minus in a 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.

To bring the record up to date, the following summarizes the year-by-year performance of the Dow, the performance of the Partnership before allocation to the general partner, and the limited partners' results for all full years of BPL's and predecessor partnerships' activities:

Year	Overall Results From Dow (1)	Partnership Results (2)	Limited Partners' Results (3)
1957	-8.4%	10.4%	9.3%
1958	38.5%	40.9%	32.2%
1959	20.0%	25.9%	20.9%
1960	-6.2%	22.8%	18.6%
1961	22.4%	45.9%	35.9%
1962	-7.6%	13.9%	11.9%
1963	20.7%	38.7%	30.5%

(1) Based on yearly changes in the value of the Dow plus dividends that would have been received through ownership of the Dow during that year.

(2) For 1957-61 consists of combined results of all predecessor limited partnerships operating throughout the entire year after all expenses but before distributions to partners or allocations to the general partner.

(3) For 1957-61 computed on the basis of the preceding column of partnership results allowing for allocation to the general partner based upon the present partnership agreement.

One wag among the limited partners has suggested I add a fourth column showing the results of the general partner --let's just say he, too, has an edge on the Dow.

The following table shows the cumulative or compounded results based on the preceding table:

Year	Overall Results From Dow	Partnership Results	Limited Partners' Results
1957	-8.4%	10.4%	9.3%
1957 – 58	26.9%	55.6%	44.5%
1957 – 59	52.3%	95.9%	74.7%

1957 – 60	42.9%	140.6%	107.2%
1957 – 61	74.9%	251.0%	181.6%
1957 – 62	61.6%	299.8%	215.1%
1957 – 63	95.1%	454.5%	311.2%
Annual Compounded Rate	10.0%	27.7%	22.3%

It appears that we have completed seven fat years. With apologies to Joseph we shall attempt to ignore the biblical script. (I've never gone overboard for Noah's ideas on diversification either.)

In a more serious vein, I would like to emphasize that, in my judgment; our 17.7 margin over the Dow shown above is unattainable over any long period of time. A ten percentage point advantage would be a very satisfactory accomplishment and even a much more modest edge would produce impressive gains as will be touched upon later. This view (and it has to be guesswork -- informed or otherwise) carries with it the corollary that we must expect prolonged periods of much narrower margins over the Dow as well as at least occasional years when our record will be inferior (perhaps substantially so) to the Dow.

Much of the above sermon is reflected in "The Ground Rules" sent to everyone in November, but it can stand repetition.

Investment Companies

We regularly compare our results with the two largest open-end investment companies (mutual funds) that follow a policy of being, typically, 95 -100% invested in common stocks, and the two largest diversified closed-end investment companies. These four companies, Massachusetts Investors Trust, Investors Stock Fund, Tri-Continental Corp. and Lehman Corp. manage about $4 billion and are probably typical of most of the $25 billion investment company industry. My opinion is that their results roughly parallel those of the vast majority or other investment advisory organizations which handle, in aggregate, vastly greater sums.

The purpose or this tabulation, which is shown below, is to illustrate that the Dow is no pushover as an index or investment achievement. The advisory talent managing just the four companies shown commands' annual fees of over $7 million, and this represents a very small fraction of the industry. The public batting average of this highly-paid talent indicates they achieved results slightly less favorable than the Dow.

Both our portfolio and method of operation differ substantially from the investment companies in the table. However, most partners, as an alternative to their interest in the Partnership would probably have their funds invested in media producing results comparable with investment companies, and I, therefore, feel they offer a meaningful standard of performance.

YEARLY RESULTS

Year	**Mass. Inv. Trust (1)**	**Investors Stock (1)**	**Lehman (2)**	**Tri-Cont. (2)**	**Dow**	**Limited Partners**
1957	-11.4%	-12.4%	-11.4%	-2.4%	-8.4%	9.3%
1958	42.7%	47.5%	40.8%	33.2%	38.5%	32.2%
1959	9.0%	10.3%	8.1%	8.4%	20.0%	20.9%
1960	-1.0%	-0.6%	2.5%	2.8%	-6.2%	18.6%
1961	25.6%	24.9%	23.6%	22.5%	22.4%	35.9%
1962	-9.8%	-13.4%	-14.4%	-10.0%	-7.6%	11.9%
1963	20.0%	16.5%	23.8%	19.5%	20.7%	30.5%

(1) Computed from changes in asset value plus any distributions to holders of record during year.

(2) From 1963 Moody's Bank & Finance Manual for 1957-62; Estimated for 1963.

COMPOUNDED

Year	Mass. Inv. Trust	Investors Stock	Lehman	Tri-Cont.	Dow	Limited Partners
1957	-11.4%	-12.4%	-11.4%	-2.4%	-8.4%	9.3%
1957 – 58	26.4%	29.2%	24.7%	30.0%	26.9%	44.5%
1957 – 59	37.8%	42.5%	34.8%	40.9%	52.3%	74.7%
1957 – 60	36.4%	41.6%	38.2%	44.8%	42.9%	107.2%
1957 – 61	71.3%	76.9%	70.8%	77.4%	74.9%	181.6%
1957 – 62	54.5%	53.2%	46.2%	59.7%	61.6%	215.1%
1957 – 63	85.4%	78.5%	81.0%	90.8%	95.1%	311.2%
Annual Compounded Rate	9.2%	8.6%	8.8%	9.7%	10.0%	22.3%

The Dow, of course, is an unmanaged index, and it may seem strange to the reader to contemplate the high priests of Wall Street striving vainly to surpass or even equal it. However, this is demonstrably the case. Moreover, such a failure cannot be rationalized by the assumption that the investment companies *et al* are handling themselves in a more conservative manner than the Dow. As the table above indicates, and as more extensive studies bear out, the behavior of common stock portfolio managed by this group, on average, have declined in concert with the Dow. By such a test of behavior in declining markets, our own methods of operation have proven to be considerably more conservative than the common stock component of the investment company or investment advisor group. While this has been true in the past, there obviously can be no guarantees about the future.

The above may seem like rather strong medicine, but it is offered as a factual presentation and in no way as criticism. Within their institutional framework and handling the many billions of dollars involved, the results achieved are the only ones attainable. To behave unconventionally within this framework is extremely difficult. Therefore, the collective record of such investment media is necessarily tied to the record of corporate America. Their merits, except in the unusual case, do not lie in superior results or greater resistance to decline in value. Rather, I feel they earn their keep by the ease of handling, the freedom from decision making and the automatic diversification they provide, plus, perhaps most important, the insulation afforded from temptation to practice patently inferior techniques which seem to entice so many world-be investors.

The Joys of Compounding

Now to the pulse-quickening portion of our essay. Last year, in order to drive home the point on compounding, I took a pot shot at Queen Isabella and her financial advisors. You will remember they were euchred into such an obviously low-compound situation as the discovery of a new hemisphere.

Since the whole subject of compounding has such a crass ring to it, I will attempt to introduce a little class into this discussion by turning to the art world. Francis I of France paid 4,000 ecus in 1540 for Leonardo da Vinci's Mona Lisa. On the off chance that a few of you have not kept track of the fluctuations of the ecu 4,000 converted out to about $20,000.

If Francis had kept his feet on the ground and he (and his trustees) had been able to find a 6% after-tax investment, the estate now would be worth something over $1,000,000,000,000,000.00. That's $1 quadrillion or over 3,000 times the present national debt, all from 6%. I trust this will end all discussion in our household about any purchase or paintings qualifying as an investment.

However, as I pointed out last year, there are other morals to be drawn here. One is the wisdom of living a long time. The other impressive factor is the swing produced by relatively small changes in the rate of compound.

Below are shown the gains from $100,000 compounded at various rates:

	4%	**8%**	**12%**	**16%**
10 Years	$48,024	$115,892	$210,584	$341,143
20 Years	$119,111	$366,094	$864,627	$1,846,060
30 Years	$224,337	$906,260	$2,895,970	$8,484,940

It is obvious that a variation of merely a few percentage points has an enormous effect on the success of a compounding (investment) program. It is also obvious that this effect mushrooms as the period lengthens. If, over a meaningful period of time, Buffett Partnership can achieve an edge of even a modest number of percentage points over the major investment media, its function will be fulfilled.

Some of you may be downcast because I have not included in the above table the rate of 22.3% mentioned on page 3. This rate, of course, is before income taxes which are paid directly by you --not the Partnership. Even excluding this factor, such a calculation would only prove the absurdity of the idea of compounding at very high rates -- even with initially modest sums. My opinion is that the Dow is quite unlikely to compound for any important length of time at the rate it has during the past seven years and, as mentioned earlier, I believe our margin over the Dow cannot be maintained at its level to date. The product of these assumptions would be a materially lower average rate of compound for BPL in the future than the rate achieved to date. Injecting a minus 30% year (which is going to happen from time to time) into our tabulation of actual results to date, with, say, a corresponding minus 40% for the Dow brings both the figures on the Dow and BPL more in line with longer range possibilities. As the compounding table above suggests, such a lowered rate can still provide highly satisfactory long term investment results.

<u>Our Method of Operation</u>

At this point I always develop literary schizophrenia. On the one hand, I know that we have in the audience a number of partners to whom details of our business are interesting. We also have a number to whom this whole thing is Greek and who undoubtedly wish I would quit writing and get back to work.

To placate both camps, I am just going to sketch briefly our three categories at this point and those who are interested in getting their doctorate can refer to the appendix for extended treatment of examples.

Our three investment categories are not differentiated by their expected profitability over an extended period of time. We are hopeful that they will each, over a ten or fifteen year period, produce something like the ten percentage point margin over the Dow that is our goal. However, in a given year they will have violently different behavior characteristics, depending primarily on the type of year it turns out to be for the stock market generally. Briefly this is how they shape up:

> “Generals” - A category of generally undervalued stocks, determined primarily by quantitative standards, but with considerable attention also paid to the qualitative factor. There is often little or 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

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 sympathy with the Dow and will turn in a big minus result during a year of substantial decline by the Dow. Contrarywise, it should be the star performer in a strongly advancing market. Over the years we expect it, of course, to achieve a satisfactory margin over the Dow.

"Workouts" - These are the securities with a timetable. They arise from corporate activity - sell-outs, mergers, reorganizations, spin-offs, etc. In this category we are not talking about rumors or "inside information" pertaining to such developments, but to publicly announced activities of this sort. We wait until we can read it in the paper. The risk pertains not primarily to general market behavior (although that is sometimes tied in to a degree), but instead to something upsetting the applecart so that the expected development does not materialize. Such killjoys could include anti-trust or other negative government action, stockholder disapproval, withholding of tax rulings, etc. The gross profits in many workouts appear quite small. A friend refers to this as getting the last nickel after the other fellow has made the first ninety-five cents. However, the predictability coupled with a short holding period produces quite decent annual rates of return. This category produces more steady absolute profits from year to year than generals do. In years of market decline, it piles up a big edge for us; during bull markets, it is a drag on performance. On a long term basis, I expect it to achieve the same sort of margin over the Dow attained by generals.

"Controls" - These are rarities, but when they occur they are likely to be of significant size. Unless we start off with the purchase of a sizable block or stock, controls develop from the general category. They result from situations where a cheap security does nothing price-wise for such an extended period of time that we are able to buy a significant percentage of the company's stock. At that point we are probably in a position to assume some degree of, or perhaps complete, control of the company's activities; whether we become active or remain relatively passive at this point depends upon our assessment of the company's future and the management's capabilities. The general we have been buying the most aggressively in recent months possesses excellent management following policies that appear to make very good sense to us. If our continued buying puts us in a controlling position at some point in the future, we will probably remain very passive regarding the operation or this business.

We do not want to get active merely for the sake of being active. Everything else being equal I would much rather let others do the work. However, when an active role is necessary to optimize the employment of capital you can be sure we will not be standing in the wings.

Active or passive, in a control situation there should be a built-in profit. The sine qua non of this operation is an attractive purchase price. Once control is achieved, the value of our investment is determined by the value of the enterprise, not the oftentimes irrationalities of the marketplace.

Our willingness and financial ability to assume a controlling position gives us two-way stretch on many purchases in our group of generals. If the market changes its opinion for the better, the security will advance in price. If it doesn't, we will continue to acquire stock until we can look to the business itself rather than the market for vindication of our judgment.

Investment results in the control category have to be measured on the basis of at least several years. Proper buying takes time. If needed, strengthening management, re-directing the utilization of capital, perhaps effecting a satisfactory sale or merger, etc., are also all factors that make this a business to be measured in years rather than months. For this reason, in controls, we are looking for wide margins of profit-if it looks at all close, we pass.

Controls in the buying stage move largely in sympathy with the Dow. In the later stages their behavior is geared more to that of workouts.

As I have mentioned in the past, the division of our portfolio among the three categories is largely determined by the accident or availability. Therefore, in a minus year for the Dow, whether we are primarily in generals or workouts is largely a matter of luck, but it will have a great deal to do with our performance relative to the Dow. This is one or many reasons why a single year's performance is of minor importance and, good or bad, should never be taken too seriously.

If there is any trend as our assets grow, I would expect it to be toward controls which heretofore have been our smallest category. I may be wrong in this expectation - a great deal depends, of course, on the future behavior of the market on which your guess is as good as mine (I have none). At this writing, we have a majority of our capital in generals, workouts rank second, and controls are third.

<u>Miscellaneous</u>

We are starting off the year with net assets of $17,454,900. Our rapid increase in assets always raises the question of whether this will result in a dilution of future performance. To date, there is more of a positive than inverse correlation between size of the Partnership and its margin over the Dow. This should not be taken seriously however. Larger sums may be an advantage at some times and a disadvantage at others. My opinion is that our present portfolio could not be improved if our assets were $1 million or $5 million. Our idea inventory has always seemed to be 10% ahead of our bank account. If that should change, you can count on hearing from me.

Susie and I have an investment of $2,392,900 in the Partnership. For the first time I had to withdraw funds in addition to my monthly payments, but it was a choice of this or disappointing the Internal Revenue Service. Susie and I have a few non-marketable (less than 300 holders) securities of nominal size left over from earlier years which in aggregate are worth perhaps 1% of our partnership interest. In addition we have one non-marketable holding of more material size of a local company purchased in 1960 which we expect to hold indefinitely. Aside from this all our eggs are in the BPL basket and they will continue to be. I can't promise results but I can promise a common destiny. In addition, that endless stream of relatives of mine consisting of my three children, mother, father, two sisters, two brothers-in-law, father-in-law, four aunts four cousins and five nieces and nephews, have interests in BPL directly or indirectly totaling $1,247,190.

Bill Scott is also in with both feet, having an interest along with his wife or $237,400, the large majority or their net worth. Bill has done an excellent job and on several or our more interesting situations going into 1964, he has done the majority or the contact work. I have also shoved off on him as much as possible of the administrative work so if you need anything done or have any questions, don't hesitate to ask for Bill if I'm not around.

Beth and Donna have kept an increasing work load flowing in an excellent manner. During December and January, I am sure they wish they had found employment elsewhere, but they always manage to keep a mountain of work ship-shape.

Peat, Marwick, Mitchell has done their usual excellent job of meeting a tough timetable. We have instructed them to conduct two surprise checks a year (rather than one as in past years) on our securities, cash, etc., in the future. These are relatively inexpensive, and I think make a good deal of sense in any financial organization.

Within the next week you will receive:

(1) A tax letter giving you all BPL information needed for your 1963 federal income tax return. This letter

is the only item that counts for tax purposes.

(2) An audit from Peat, Marwick, Mitchell & Co. for 1963, setting forth the operations and financial position of BPL as well as your own capital account.

(3) A letter signed by me setting forth the status of your BPL interest on 1/1/64. This is identical with the figure developed in the audit.

(4) Schedule "A" to the partnership agreement listing all partners.

Let me know if anything needs clarifying. As we grow, there is more chance of missing letters, a name skipped over, a figure transposition, etc., so speak up if it appears we might have erred. Our next letter will be about July 15th summarizing the first half.

Cordially,

Warren E. Buffett

APPENDIX

TEXAS NATIONAL PETROLEUM

This situation was a run-of-the-mill workout arising from the number one source of workouts in recent years -- the sellouts of oil and gas producing companies.

TNP was a relatively small producer with which I had been vaguely familiar for years.

Early in 1962 I heard rumors regarding a sellout to Union Oil of California. I never act on such information, but in this case it was correct and substantially more money would have been made if we had gone in at the rumor stage rather than the announced stage. However, that's somebody else's business, not mine.

In early April, 1962, the general terms of the deal were announced. TNP had three classes of securities outstanding:

(1) 6 1/2% debentures callable at 104 1/4 which would bear interest until the sale transpired and at that time would be called. There were $6.5 million outstanding of which we purchased $264,000 principal amount before the sale closed.

(2) About 3.7 million shares of common stock of which the officers and directors owned about 40%. The proxy statement estimated the proceeds from the liquidation would produce $7.42 per share. We purchased 64,035 shares during the six months or so between announcement and closing.

(3) 650,000 warrants to purchase common stock at $3.50 per share. Using the proxy statement estimate of $7.42 for the workout on the common resulted in $3.92 as a workout on the warrants. We were able to buy 83,200 warrants or about 13% of the entire issue in six months.

The risk of stockholder disapproval was nil. The deal was negotiated by the controlling stockholders, and the price was a good one. Any transaction such as this is subject to title searches, legal opinions, etc., but this risk could also be appraised at virtually nil. There were no anti-trust problems. This absence of legal or anti-trust problems is not always the case, by any means.

The only fly in the ointment was the obtaining of the necessary tax ruling. Union Oil was using a standard ABC production payment method of financing. The University of Southern California was the production payment holder and there was some delay because of their eleemosynary status.

This posed a new problem for the Internal Revenue Service, but we understood USC was willing to waive this status which still left them with a satisfactory profit after they borrowed all the money from a bank. While getting this ironed out created delay, it did not threaten the deal.

When we talked with the company on April 23rd and 24th, their estimate was that the closing would take place in August or September. The proxy material was mailed May 9th and stated the sale "will be consummated during the summer of 1962 and that within a few months thereafter the greater part of the proceeds will be distributed to stockholders in liquidation." As mentioned earlier, the estimate was $7.42 per share.
Bill Scott attended the stockholders meeting in Houston on May 29th where it was stated they still expected to close on September 1st.

The following are excerpts from some of the telephone conversations we had with company officials in ensuing months:

> On June 18th the secretary stated "Union has been told a favorable IRS ruling has been formulated but must be passed on by additional IRS people. Still hoping for ruling in July."
>
> On July 24th the president said that he expected the IRS ruling "early next week."
>
> On August 13th the treasurer informed us that the TNP, Union Oil, and USC people were all in Washington attempting to thrash out a ruling.
>
> On September 18th the treasurer informed us "No news, although the IRS says the ruling could be ready by next week."

The estimate on payout was still $7.42.

The ruling was received in late September, and the sale closed October 31st. Our bonds were called November 13th. We converted our warrants to common stock shortly thereafter and received payments on the common of $3.50 December 14, 1962, $3.90 February 4, 1963, and 15 cent on April 24, 1963. We will probably get another 4 cent in a year or two. On 147,235 shares (after exercise of warrants) even 4 cent per share is meaningful.

This illustrates the usual pattern: (1) the deals take longer than originally projected; and (2) the payouts tend to average a little better than estimates. With TNP it took a couple of extra months, and we received a couple of extra percent.

The financial results of TNP were as follows:

(1) On the bonds we invested $260,773 and had an average holding period of slightly under five months. We received 6 ½% interest on our money and realized a capital gain of $14,446. This works out to an overall rate of return of approximately 20% per annum.

(2) On the stock and warrants we have realized capital gain of $89,304, and we have stubs presently valued at $2,946. From an investment or $146,000 in April, our holdings ran to $731,000 in October. Based on the time the money was employed, the rate or return was about 22% per annum.

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.

We are not presenting TNP as any earth-shaking triumph. We have had workouts which were much better and some which were poorer. It is typical of our bread-and-butter type of operation. We attempt to obtain all facts possible, continue to keep abreast of developments and evaluate all of this in terms of our experience. We certainly don't go into all the deals that come along -- there is considerable variation in their attractiveness. When a workout falls through, the resulting market value shrink is substantial. Therefore, you cannot afford many errors, although we fully realize we are going to have them occasionally.

<u>DEMPSTER MILL MFG.</u>

This situation started as a general in 1956. At that time the stock was selling at $18 with about $72 in book value of which $50 per share was in current assets (Cash, receivables and inventory) less all liabilities. Dempster had earned good money in the past but was only breaking even currently.

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 say at the time of purchase, but the group expectancy is favorable, whether the impetus is from an improved industry situation, a takeover offer, a change in investor psychology, etc.

We continued to buy the stock in small quantities for five years. During most or this period I was a director and was becoming consistently less impressed with the earnings prospects under existing management. However, I also became more familiar with the assets and operations and my evaluation of the quantitative factors remained very favorable.

By mid-1961 we owned about 30% or Dempster (we had made several tender offers with poor results), but in August and September 1961 made, several large purchases at $30.25 per share, which coupled with a subsequent tender offer at the same price, brought our holding to over 70%. Our purchases over the previous five years had been in the $16-$25 range.

On assuming control, we elevated the executive vice president to president to see what he would do unfettered by the previous policies. The results were unsatisfactory and on April 23, 1962 we hired Harry Bottle as president.

Harry was the perfect man for the job. I have recited his triumphs before and the accompanying comparative balance sheets speak louder than any words in demonstrating the re-employment of capital.

	11/30/61	**7/31/63 (unaudited)**
Cash	$166,000	$89,000
US Gov't Securities – at cost		$289,000
Other marketable securities – at market (which exceeds cost)		$2,049,000
Total Cash and Securities	**$166,000**	**$2,436,000**
Accounts receivable (net)	$1,040,000	$864,000
Inventory	$4,203,000	$890,000
Prepaid expenses, etc.	$82,000	$12,000
Current Assets	**$5,491,000**	**$4,202,000**
Other Assets	$45,000	$62,000
Net Plant and Equipment	$1,383,000	$862,000
Total Assets	**$6,919,000**	**$5,126,000**
Notes Payable	$1,230,000	
Other Liability	$1,088,000	$274,000
Total Liabilities	**$2,318,000**	**$274,000**
Net worth 60,146 shs. 11/30/61 62,146 shs. 7/31/63	$4,601,000	$4,852,000
Total liabilities and net worth	**$6,919,000**	**$5,126,000**

Harry:

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

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

$400,000

(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;

(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;

(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.

In 1963, the heavy corporate taxes we were facing (Harry surprised me by the speed with which he had earned up our tax loss carry-forward) coupled with excess liquid funds within the corporation compelled us to either in some way de-incorporate or to sell the business.

We set out to do either one or the other before the end of 1963. De-incorporating had many problems but would have, in effect, doubled earnings for our partners and also eliminated the problem of corporate capital gain tax on Dempster securities.

At virtually the last minute, after several earlier deals had fallen through at reasonably advanced stages, a sale of assets was made. Although there were a good many wrinkles to the sale, the net effect was to bring approximately book value. This, coupled with the gain we have in our portfolio of marketable securities, gives us a realization of about $80 per share. Dempster (now named First Beatrice Corp. - we sold the name to the new Co.) is down to almost entirely cash and marketable securities now. On BPL's yearend audit, our First Beatrice holdings were valued at asset value (with securities at market) less a $200,000 reserve for various contingencies.

I might mention that we think the buyers will do very well with Dempster. They impress us as people of ability and they have sound plans to expand the business and its profitability. We would have been quite happy to operate Dempster on an unincorporated basis, but we are also quite happy to sell it for a reasonable price. Our business is making excellent purchases -- not making extraordinary sales.

Harry works the same way I do -- he likes big carrots. He is presently a limited partner of BPL, and the next belt-tightening operation we have, he's our man.

The Dempster saga points up several morals:

(1) Our business is one requiring patience. It has little in common with a portfolio of high-flying glamour stocks and during periods of popularity for the latter, we may appear quite stodgy.

    It is to our advantage to have securities do nothing price wise for months, or perhaps years, why we are buying them. This points up the need to measure our results over an adequate period of time. We suggest three years as a minimum.

(2) We cannot talk about our current investment operations. Such an open-mouth policy could never improve our results and in some situations could seriously hurt us. For this reason, should anyone, including partners, ask us whether we are interested in any security, we must plead the "5th Amendment."

BUFFETT PARTNERSHIP, LTD.
810 KIEWIT PLAZA
OMAHA 31, NEBRASKA

July 8, 1964

First Half Performance

The whole family is leaving for California on June 23rd so I am fudging a bit on this report and writing it June 18th. However, for those of you who set your watches by the receipt of our letters. I will maintain our usual chronological symmetry in reporting, leaving a few blanks which Bill will fill in after the final June 30th figures are available.

During the first half of 1964 the Dow-Jones Industrial Average (hereinafter called the "DOW") advanced from 762.95 to 831.50. If one had owned the Dow during this period, dividends of approximately 14.40 would have been received, bringing the overall return from the Dow during the first half to plus 10.0%. As I write this on June 18th, it appears that our results will differ only insignificantly from those of the Dow. I would feel much better reporting to you that the Dow had broken even, and we had been plus 5%, or better still, that the Dow had been minus 10%, and we had broken even. I have always pointed out, however, that gaining an edge on the Dow is more difficult for us in advancing markets than in static or declining ones.

To bring the record up to date, the following summarizes the performance of the Dow, the performance of the Partnership before allocation to the general partner and the limited partners' results:

Year	**Overall Results From Dow (1)**	**Partnership Results (2)**	**Limited Partners' Results (3)**
1957	-8.4%	10.4%	9.3%
1958	38.5%	40.9%	32.2%
1959	20.0%	25.9%	20.9%
1960	-6.2%	22.8%	18.6%
1961	22.4%	45.9%	35.9%
1962	-7.6%	13.9%	11.9%
1963	20.6%	38.7%	30.5%
1st half 1964	10.9%	12.0%	10.5%
Cumulative results	**116.1%**	**521.0%**	**354.4%**
Annual compounded rate	**10.8%**	**27.6%**	**22.2%**

(See next page for footnotes to table.)

Footnotes to preceding table:

(1) Based on yearly changes in the value of the Dow plus dividends that would have been received through ownership of the Dow during that year. The table includes all complete years of partnership activity.

(2) For 1957-61 consists of combined results of all predecessor limited partnerships operating throughout the entire year after all expenses but before distributions to partners or allocations to the general partner.

(3) For 1957-61 computed on the basis of the preceding column of partnership results allowing for

allocation to the general partner based up on the present partnership agreement, but before monthly withdrawals by limited partners.

Buying activities during the first half were quite satisfactory. This is of particular satisfaction to me since I consider the buying end to be about 90% of this business. Our General category now includes three companies where B.P.L. is the largest single stockholder. These stocks have been bought and are continuing to be bought at prices considerably below their value to a private owner. We have been buying one of these situations for approximately eighteen months and both of the others for about a year. It would not surprise me if we continue to do nothing but patiently buy these securities week after week for at least another year, and perhaps even two years or more.

What we really like to see in situations like the three mentioned above is a condition where the company is making substantial progress in terms of improving earnings, increasing asset values, etc., but where the market price of the stock is doing very little while we continue to acquire it. This doesn't do much for our short-term performance, particularly relative to a rising market, but it is a comfortable and logical producer of longer-term profits. Such activity should usually result in either appreciation of market prices from external factors or the acquisition by us of a controlling position in a business at a bargain price. Either alternative suits me.

It is important to realize, however, that most of our holdings in the General category continue to be securities which we believe to be considerably undervalued, but where there is not the slightest possibility that we could have a controlling position. We expect the market to justify our analyses of such situations in a reasonable period of time, but we do not have the two strings to our bow mentioned in the above paragraph working for us in these securities.

Investment Companies

We regularly compare our results with the two largest open-end investment companies (mutual funds) that follow a policy of being typically 95%-100% invested in common stocks, and the two largest diversified closed-end investment companies. These four companies, Massachusetts Investors Trust, Investors Stock Fund, Tri-Continental Corp., and Lehman Corp., manage over $4 billion and are probably typical of most of the $28 billion investment company industry. Their results are shown below. My opinion is that this performance roughly parallels that of the overwhelming majority of other investment advisory organizations which handle, in aggregate, vastly greater sums.

Year	**Mass. Inv. Trust (1)**	**Investors Stock (1)**	**Lehman (2)**	**Tri-Cont. (2)**	**Dow**	**Limited Partners**
1957	-11.4%	-12.4%	-11.4%	-2.4%	-8.4%	9.3%
1958	42.7%	47.5%	40.8%	33.2%	38.5%	32.2%
1959	9.0%	10.3%	8.1%	8.4%	20.0%	20.9%
1960	-1.0%	-0.6%	2.5%	2.8%	-6.2%	18.6%
1961	25.6%	24.9%	23.6%	22.5%	22.4%	35.9%
1962	-9.8%	-13.4%	-14.4%	-10.0%	-7.6%	11.9%
1963	20.0%	16.5%	23.7%	18.3%	20.6%	30.5%
1st half 1964	11.0%	9.5%	9.6%	8.6%	10.9%	10.5%
Cumulative Results	105.8%	95.5%	98.2%	105.1%	116.1%	354.4%
Annual Compounded Rate	10.1%	9.4%	9.6%	10.1%	10.8%	22.2%

(1) Computed from changes in asset value plus any distributions to holders of record during year.

(2) From 1964 Moody's Bank & Finance Manual for 1957-63. Estimated for first half 1964.

These figures continue to show that the most highly paid and respected investment management has difficulty matching the performance of an unmanaged index of blue chip stocks. The results of these companies in some ways resemble the activity of a duck sitting on a pond. When the water (the market) rises, the duck rises; when it falls, back goes the duck. SPCA or no SPCA, I think the duck can only take the credit (or blame) for his own activities. The rise and fall of the lake is hardly something for him to quack about. The water level has been of great importance to B.P.L's performance as the table on page one indicates. However, we have also occasionally flapped our wings.

I would like to emphasize that I am not saying that the Dow is the only way of measuring investment performance in common stocks. However, I do say that all investment managements (including self-management) should be subjected to objective tests, and that the standards should be selected a priori rather than conveniently chosen retrospectively.

The management of money is big business. Investment managers place great stress on evaluating company managements in the auto industry, steel industry, chemical industry, etc. These evaluations take enormous amounts of work, are usually delivered with great solemnity, and are devoted to finding out which companies are well managed and which companies have management weaknesses. After devoting strenuous efforts to objectively measuring the managements of portfolio companies, it seems strange indeed that similar examination is not applied to the portfolio managers themselves. We feel it is essential that investors and investment managements establish standards of performance and, regularly and objectively, study their own results just as carefully as they study their investments.

We will regularly follow this policy wherever it may lead. It is perhaps too obvious to say that our policy of measuring performance in no way guarantees good results--it merely guarantees objective evaluation. I want to stress the points mentioned in the "Ground Rules" regarding application of the standard--namely that it should be applied on at least a three-year basis because of the nature of our operation and also that during a speculative boom we may lag the field. However, one thing I can promise you. We started out with a 36-inch yardstick and we'll keep it that way. If we don't measure up, we won't change yardsticks. In my opinion, the entire field of investment management, involving hundreds of billions of dollars, would be more satisfactorily conducted if everyone had a good yardstick for measurement of ability and sensibly applied it. This is regularly done by most people in the conduct of their own business when evaluating markets, people, machines, methods, etc., and money management is the largest business in the world.

Taxes

We entered 1964 with net unrealized gains of $2,991,090 which is all attributable to partners belonging during 1963. Through June 30th we have realized capital gains of $2,826,248.76 (of which 96% are long term) so it appears very likely that at least all the unrealized appreciation attributable to your interest and reported to you in our letter of January 25, 1964, (item 3) will be realized this year. I again want to emphasize that this has nothing to do with how we are doing. It is possible that I could have made the above statement, and the market value of your B.P.L. interest could have shrunk substantially since January 1st, so the fact that we have large realized gains is no cause for exultation. Similarly when our realized gains are very small there is not necessarily any reason to be discouraged. We do not play any games to either accelerate or defer taxes. We make investment decisions based on our evaluation of the most profitable combination of probabilities. If this means paying taxes I'm glad the rates on long-term capital gains are as low as they are.

As previously stated in our most recent tax letter of April 1, 1964 the safe course to follow on interim estimates is to pay the same estimated tax for 1964 as your actual tax was for 1963. There can be no penalties if you follow this procedure.

The tax liability for partners who entered January 1st will, of course, be quite moderate, as it always is in the first year for any partner. This occurs because realized capital gains are first attributed to old partners having an interest in unrealized appreciation. This, again, of course, has nothing to do with economic performance. All limited partners, new and old, (except for Bill Scott, Ruth Scott and Susan Buffett per paragraph five of the Partnership Agreement) end up with exactly the same results. As usual, net ordinary income for all partners is nominal to date.

As in past years, we will have a letter out about November 1st (to partners and those who have indicated an interest, to us by that time in becoming partners) with the amendment to the Partnership Agreement, Commitment Letter for 1965, estimate or the 1964 tax situation, etc. In the meantime, keep Bill busy this summer clearing up anything in this letter that comes out fuzzy.

Cordially,

Warren E. Buffett

BUFFETT PARTNERSHIP, LTD.
810 KIEWIT PLAZA
OMAHA 31, NEBRASKA

January 18, 1965

Our Performance in 1964

Although we had an overall gain of $4,846,312.37 in 1964, it was not one of our better years as judged by our fundamental yardstick, the Dow-Jones Industrial Average (hereinafter called the "Dow"). The overall result for BPL was plus 27.8% compared to an overall plus 18.7% for the Dow. The overall result for limited partners was plus 22.3%. Both the advantage of 9.1 percentage points on a partnership basis and 3.6 points by the limited partners were the poorest since 1959, which was a year of roughly comparable gains for the Dow.

Nevertheless, I am not depressed. It was a strong year for the general market, and it is always tougher for us to outshine the Dow in such a year. We are certain to have years when the Dow gives us a drubbing and, in some respects, I feel rather fortunate that 1964 wasn't the year. Because of the problems that galloping markets pose for us, a Dow repeat in 1965 of 1964 results would make it most difficult for us to match its performance, let alone surpass it by a decent margin.

To bring the record up to date, the following summarizes the year-by-year performance of the Dow, the performance of the Partnership before allocation to the general partner, and the limited partner's results:

Year	**Overall Results From Dow (1)**	**Partnership Results (2)**	**Limited Partners' Results (3)**
1957	-8.4%	10.4%	9.3%
1958	38.5%	40.9%	32.2%
1959	20.0%	25.9%	20.9%
1960	-6.2%	22.8%	18.6%
1961	22.4%	45.9%	35.9%
1962	-7.6%	13.9%	11.9%
1963	20.6%	38.7%	30.5%
1964	18.7%	27.8%	22.3%

(1) Based on yearly changes in the value of the Dow plus dividends that would have been received through ownership of the Dow during that year. The table includes all complete years of partnership activity.

(2) For 1957-61 consists of combined results of all predecessor limited partnerships operating throughout the entire year after all expenses, but before distributions to partners or allocations to the general partner.

(3) For 1957-61 computed on the basis of the preceding column of partnership results allowing for allocation to the general partner based upon the present partnership agreement, but before monthly withdrawals by limited partners.

On a cumulative or compounded basis, the results are:

Year	**Overall Results From Dow**	**Partnership Results**	**Limited Partners' Results**
1957	-8.4%	10.4%	9.3%
1957 – 58	26.9%	55.6%	44.5%

1957 – 59	52.3%	95.9%	74.7%
1957 – 60	42.9%	140.9%	107.2%
1957 – 61	74.9%	251.0%	181.6%
1957 – 62	61.6%	299.8%	215.1%
1957 – 63	94.9%	454.5%	311.2%
1957 – 64	131.3%	608.7%	402.9%
Annual Compounded Rate	**11.1%**	**27.7%**	**22.3%**

Investment Companies

We regularly compare our results with the two largest open-end investment companies (mutual funds) that follow a policy of being typically 95-100% invested in common stock, and the two largest diversified closed-end investment companies. These four companies, Massachusetts Investors Trust, Investors Stock Fund, Tri-Continental Corporation, and Lehman Corporation, manage about $4.5 billion, are owned by about 550,000 shareholders, and are probably typical of most of the $30 billion investment company industry. My opinion is that their results roughly parallel those of the overwhelming majority of other investment advisory organizations which handle, in aggregate, vastly greater sums.

The purpose of this tabulation, which is shown below, is to illustrate that the Dow is no pushover as an index of investment achievement. The advisory talent managing just the four companies shown commands annual fees of over $8 million and this represents a very small fraction of the professional investment management industry. The public batting average of this highly-paid and widely respected talent indicates performance a shade below that of the Dow, an unmanaged index.

YEARLY RESULTS

Year	Mass. Inv. Trust (1)	Investors Stock (1)	Lehman (2)	Tri-Cont (2)	Dow	Limited Partners
1957	-11.4%	-12.4%	-11.4%	-2.4%	-8.4%	9.3%
1958	42.7%	47.5%	40.8%	33.2%	38.5%	32.2%
1959	9.0%	10.3%	8.1%	8.4%	20.0%	20.9%
1960	-1.0%	-0.6%	2.5%	2.8%	-6.2%	18.6%
1961	25.6%	24.9%	23.6%	22.5%	22.4%	35.9%
1962	-9.8%	-13.4%	-14.4%	-10.0%	-7.6%	11.9%
1963	20.0%	16.5%	23.7%	18.3%	20.6%	30.5%
1964	15.9%	14.3%	13.6%	12.6%	18.7%	22.3%

(1) Computed from changes in asset value plus any distributions to holders of record during year.

(2) From 1964 Moody's Bank & Finance Manual for 1957-63. Estimated for 1964.

COMPOUNDED

Year	Mass. Inv. Trust (1)	Investors Stock (1)	Lehman (2)	Tri-Cont (2)	Dow	Limited Partners
1957	-11.4%	-12.4%	-11.4%	-2.4%	-8.4%	9.3%
1957 – 58	26.4%	29.2%	24.7%	30.0%	26.9%	44.5%
1957 – 59	37.8%	42.5%	34.8%	40.9%	52.3%	74.7%
1957 – 60	36.4%	41.6%	38.2%	44.8%	42.9%	107.2%

1957 – 61	71.3%	76.9%	70.8%	77.4%	74.9%	181.6%
1957 – 62	54.5%	53.2%	46.2%	59.7%	61.6%	215.1%
1957 – 63	85.4%	78.5%	80.8%	88.9%	94.9%	311.2%
1957 – 64	114.9%	104.0%	105.4%	112.7%	131.3%	402.9%
Annual Compounded Rate	**10.0%**	**9.3%**	**9.4%**	**9.9%**	**11.1%**	**22.3%**

The repetition of these tables has caused partners to ask: "Why in the world does this happen to very intelligent managements working with (1) bright, energetic staff people, (2) virtually unlimited resources, (3) the most extensive business contacts, and (4) literally centuries of aggregate investment experience?" (The latter qualification brings to mind the fellow who applied for a job and stated he had twenty years of experience - which was corrected by the former employer to read “one year's experience -twenty times.”)

This question is of enormous importance, and you would expect it to be the subject of considerable study by investment managers and substantial investors. After all, each percentage point on $30 billion is $300 million per year. Curiously enough, there is practically nothing in the literature of Wall Street attracting this problem, and discussion of it is virtually absent at security analyst society meetings, conventions, seminars, etc. My opinion is that the first job of any investment management organization is to analyze its own techniques and results before pronouncing judgment on the managerial abilities and performance of the major corporate entities of the United States.

In the great majority of cases the lack of performance exceeding or even matching an unmanaged index in no 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.

Perhaps the above comments are unjust. Perhaps even our statistical comparisons are unjust. Both our portfolio and method of operation differ substantially from the investment companies in the table. However, I believe both our partners and their stockholders feel their managements are seeking the same goal - the maximum long-term average return on capital obtainable with the minimum risk of permanent loss consistent with a program of continuous investment in equities. Since we should have common goals, and most partners, as an alternative to their interest in BPL, would probably have their funds invested in media producing results comparable with these investment companies, I feel their performance record is meaningful in judging our own results.

There is no question that an important service is provided to investors by investment companies, investment advisors, trust departments, etc. This service revolves around the attainment of adequate diversification, the preservation of a long-term outlook, the ease of handling investment decisions and mechanics, and most importantly, the avoidance of the patently inferior investment techniques which seem to entice some individuals. All but a few of the organizations do not specifically promise to deliver superior investment performance although it is perhaps not unreasonable for the public to draw such an inference from their advertised emphasis on professional management.

One thing I pledge to you as partners - just as I consider the previously stated performance comparison to be meaningful now, so will I in future years, no, matter what tale unfolds. Correspondingly, I ask that you, if you do not feel such a standard to be relevant, register such disagreement now and suggest other standards which can be applied prospectively rather than retrospectively.

One additional thought - I have not included a column in my table for the most widely-used investment advisor in the world - Bell management. People who watch their weight, golf scores, and fuel bills seem to shun quantitative evaluation of their investment management skills although it involves the most important client in the world - themselves. While it may be of academic interest to evaluate the management accomplishments of 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.

The Question of Conservatism

In looking at the table of investment company performance, the question might be asked: “Yes, but aren't those companies run more conservatively than the Partnership?" If you asked that question of the investment company managements, they, in absolute honesty, would say they were more conservative. If you asked the first hundred security analysts you met, I am sure that a very large majority of them also would answer for the investment companies. I would disagree. I have over 90% of my net worth in BPL, and most of my family have percentages in that area, but of course, that only demonstrates the sincerity of my view - not the validity of it.

It is unquestionably true that the investment companies have their money more conventionally invested than we do. To many people conventionality is indistinguishable from conservatism. In my view, this represents erroneous thinking. Neither a conventional nor an unconventional approach, per se, is conservative.

Truly conservative actions arise from intelligent hypotheses, correct facts and sound reasoning. These qualities may lead to conventional acts, but there have been many times when they have led to unorthodoxy. In some corner of the world they are probably still holding regular meetings of the Flat Earth Society.

We derive no comfort because important people, vocal people, or great numbers of people agree with us. Nor do we derive comfort if they don't. A public opinion poll is no substitute for thought. When we really sit back with a smile on our face is when we run into a situation we can understand, where the facts are ascertainable and clear, and the course of action obvious. In that case - whether other conventional or unconventional - whether others agree or disagree - we feel - we are progressing in a conservative manner.

The above may seem highly subjective. It is. You should prefer an objective approach to the question. I do. My suggestion as to one rational way to evaluate the conservativeness of past policies is to study performance in declining markets. We have only three years of declining markets in our table and unfortunately (for purposes of this test only) they were all moderate declines. In all three of these years we achieved appreciably better investment results than any of the more conventional portfolios.

Specifically, if those three years had occurred in sequence, the cumulative results would have been:

Tri-Continental Corp.	-9.7%
Dow	-20.6%
Mass. Investors Trust	-20.9%
Lehman Corp.	-22.3%
Investors Stock Fund	-24.6%
Limited Partners	+45.0%

We don’t think this comparison is all important, but we do think it has some relevance. We certainly think it makes more sense than saying “We own (regardless of price) A.T. &T., General Electric, IBM and General Motors and are therefore conservative.” In any event, evaluation of the conservatism of any investment program or management (including self-management) should be based upon rational objective standards, and I suggest performance in declining markets to be at least one meaningful test.

<u>The Joys of Compounding</u>

Readers of our early annual letters registered discontent at a mere recital of contemporary investment experience, but instead hungered for the intellectual stimulation that only could be provided by a depth study of investment strategy spanning the centuries. Hence, this section.

Our last two excursions into the mythology of financial expertise have revealed that purportedly shrewd investments by Isabella (backing the voyage of Columbus) and Francis I (original purchase of Mona Lisa) bordered on fiscal lunacy. Apologists for these parties have presented an array of sentimental trivia. Through it all, our compounding tables have not been dented by attack.

Nevertheless, one criticism has stung a bit. The charge has been made that this column has acquired a negative tone with only the financial incompetents of history receiving comment. We have been challenged to record on these pages a story of financial perspicacity which will be a bench mark of brilliance down through the ages.

One story stands out. This, of course, is the saga of trading acumen etched into history by the Manhattan Indians when they unloaded their island to that notorious spendthrift, Peter Minuit in 1626. My understanding is that they received $24 net. For this, Minuit received 22.3 square miles which works out to about 621,688,320 square feet. While on the basis of comparable sales, it is difficult to arrive at a precise appraisal, a $20 per square foot estimate seems reasonable giving a current land value for the island of $12,433,766,400 ($12 1/2 billion). To the novice, perhaps this sounds like a decent deal. However, the Indians have only had to achieve a 6 1/2% return (The tribal mutual fund representative would have promised them this.) to obtain the last laugh on Minuit. At 6 1/2%, $24 becomes $42,105,772,800 ($42 billion) in 338 years, and if they just managed to squeeze out an extra half point to get to 7%, the present value becomes $205 billion.

So much for that.

Some of you may view your investment policies on a shorter term basis. For your convenience, we include our usual table indicating the gains from compounding $100,000 at various rates:

	4%	8%	12%	16%
10 Years	$48,024	$115,892	$210,584	$341,143
20 Years	$119,111	$366,094	$864,627	$1,846,060
30 Years	$224,337	$906,260	$2,895,970	$8,484,940

This table indicates the financial advantages of:

(1) A long life (in the erudite vocabulary of the financial sophisticate this is referred to as the Methusalah Technique)

(2) A high compound rate

(3) A combination of both (especially recommended by this author)

To be observed are the enormous benefits produced by relatively small gains in the annual earnings rate. This explains our attitude which while hopeful of achieving a striking margin of superiority over average investment results, nevertheless, regards every percentage point of investment return above average as having real meaning.

<u>Our Goal</u>

You will note that there are no columns in the preceding table for the 27.7% average of the Partnership during its eight-year lifespan or the 22.3% average of the limited partners. Such figures are nonsensical for the long term for several reasons: (Don't worry about me "holding back" to substantiate this prophecy.)

(1) Any significant sums compounded at such rates take on national debt proportions at alarming speed.

(2) During our eight-year history a general revaluation of securities has produced average annual rates of overall gain from the whole common stock field which I believe unattainable in future decades. Over a span of 20 or 30 years, I would expect something more like 6% - 7% overall annual gain from the Dow instead of the 11.1% during our brief history. This factor alone would tend to knock 4 points or so off of our annual compounding rate. It would only take a minus 20.5% year in 1965 for the Dow to bring it down to a 7% average figure for the nine years. Such years (or worse) should definitely be expected from time to time by those holding equity investments. If a 20% or 30% drop in the market value of your equity holdings (such as BPL) is going to produce emotional or financial distress, you should simply avoid common stock type investments. In the words of the poet - Harry Truman – "If you can't stand the heat, stay out of the kitchen. It is preferable, of course, to consider the problem before you enter the "kitchen."

(3) We do not consider it possible on an extended basis to maintain the 16.6 percentage point advantage over the Dow of the Partnership or the 11.2 percentage point edge enjoyed by the limited partners. We have had eight consecutive years in which our pool of money has out-performed the Dow, although the profit allocation arrangement left the limited partners short of Dow results in one of those years. We are certain to have years (note the plural) when the Partnership results fall short of the Dow despite considerable gnashing of teeth by the general partner (I hope not too much by the limited partners). When that happens our average margin of superiority will drop sharply. I might say that I also think we will continue to have some years of very decent margins in our favor. However, to date we have benefited by the fact that we have not had a really mediocre (or worse) year included in our average, and this obviously cannot be expected to be a permanent experience.

So what can we expect to achieve? Of course, anything I might say is largely guesswork, and my own investment philosophy has developed around the theory that prophecy reveals far more of the frailties of the prophet than it reveals of the future.

Nevertheless, you, as partners, are entitled to know my expectations, tenuous as they may be. I am hopeful that our longer term experience will unfold along the following basis:

(1) An overall gain from the Dow (including dividends, of course) averaging in the area of 7% per annum, exhibiting customarily wide amplitudes in achieving this average -- say, on the order or minus 40% to plus 50% at the extremes with the majority of years in the minus 10% to plus 20% range;

(2) An average advantage of ten percentage points per annum for BPL before allocation to the general partner - again with large amplitudes in the margin from perhaps 10 percentage points worse than the Dow in a bad year to 25 percentage points better when everything clicks; and

(3) The product of these two assumptions gives an average of 17% to BPL or about 14% to limited partners. This figure would vary enormously from year to year; the final amplitudes, of course, depending, on the interplay of the extremes hypothesized in (1) and (2).

I would like to emphasize that the above is conjecture, perhaps heavily influenced by self-interest, ego, etc. Anyone with a sense of financial history knows this sort of guesswork is subject to enormous error. It might better be left out of this letter, but it is a question frequently and legitimately asked by partners. Long-range expectable return is the primary consideration of all of us belonging to BPL, and it is reasonable that I should be put on record, foolish as that may later make me appear. My rather puritanical view is that any investment manager, whether operating as broker, investment counselor, trust department, Investment Company, etc., should be willing to state unequivocally what he is going to attempt to accomplish and how he proposes to measure the extent to which he gets the job done.

Our Method of Operation

In past annual letters I have always utilized three categories to describe investment operations we conduct. I now feel that a four-category division is more appropriate. Partially, the addition of a new section - "Generals Relatively Undervalued" - reflects my further consideration of essential differences that have always existed to a small extent with our "Generals" group. Partially, it reflects the growing importance of what once was a very small sub-category but is now a much more significant part of our total portfolio. This increasing importance has been accompanied by excellent results to date justifying significant time and effort devoted to finding additional opportunities in this area. Finally, it partially reflects the development and implementation of a new and somewhat unique investment technique designed to improve the expectancy and consistency of operations in this category. Therefore, our four present categories are:

1. "Generals -Private Owner Basis" - a category of generally undervalued stocks, determined by quantitative standards, but with considerable attention also paid to the qualitative factor. There is often little or 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 of the enterprise substantially below what careful analysis indicates its value to a private owner to be. Again, let me emphasize that 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.

Many times in this category we have the desirable "two strings to our bow" situation where we should either achieve appreciation of market prices from external factors or from the acquisition of a controlling position in a business at a bargain price. While the former happens in the overwhelming majority of cases, the latter represents an insurance policy most investment operations don't have. We have continued to enlarge the positions in the three companies described in our 1964 midyear report where we are the largest stockholder. All three companies are increasing their fundamental value at a very satisfactory rate, and we are completely passive in two situations and active only on a very minor scale in the third. It is unlikely that we will ever take a really active part in policy-making in any of these three companies, but we stand ready if needed.

2. "Generals -Relatively Undervalued" - this category consists of securities selling at prices relatively cheap compared to securities of the same general quality. We demand substantial discrepancies from current valuation standards, but (usually because of large size) do not feel value to a private owner to be a meaningful concept. It is important in this category, of course, that apples be compared to apples - and not to oranges, and we work hard at achieving that end. In the great majority of cases we simply do not know enough about the industry or company to come to sensible judgments -in that situation we pass.

As mentioned earlier, this new category has been growing and has produced very satisfactory results. We have recently begun to implement a technique, which gives promise of very substantially reducing the risk from an overall change in valuation standards; e.g. I we buy something at 12 times earnings when comparable or poorer quality companies sell at 20 times earnings, but then a major revaluation takes place so the latter only sell at 10 times.
This risk has always bothered us enormously because of the helpless position in which we could be left compared to the "Generals -Private Owner" or "Workouts" types. With this risk diminished, we think this category has a promising future.

3. "Workouts" - these are the securities with a timetable. They arise from corporate activity - sell-outs, mergers, reorganizations, spin-offs, etc. In this category we are not talking about rumors or "inside information" pertaining to such developments, but to publicly announced activities of this sort. We wait until we can read it in the paper. The risk pertains not primarily to general market behavior (although that is sometimes tied in to a degree), but instead to something upsetting the applecart so that the expected development does not materialize. Such killjoys could include anti-trust or other negative government action, stockholder disapproval, withholding of tax rulings, etc. The gross profits in many workouts appear quite small. It's a little like looking for parking meters with some time left on them. However, the predictability coupled with a short holding period produces quite decent average annual rates of return after allowance for the occasional substantial loss. This category produces more steady absolute profits from year to year than generals do. In years of market decline it should usually pile up a big edge for us; during bull markets it will probably be a drag on performance. On a long-term basis, I expect the workouts to achieve the same sort of margin over the Dow attained by generals.

4. "Controls" - these are rarities, but when they occur they are likely to be of significant size. Unless we start off with the purchase of a sizable block of stock, controls develop from the general - private owner category. They result from situations where a cheap security does nothing pricewise for such an extended period of time that we are able to buy a significant percentage of the company's stock. At that point we are probably in a position to assume a degree of or perhaps complete control of the company's activities. Whether we become active or remain relatively passive at this point depends upon our assessment of the company's future and the managements capabilities.

We do not want to get active merely for the sake of being active. Everything else being equal, I would much rather let others do the work. However, when an active role is necessary to optimize the employment of capital, you can be sure we will not be standing in the wings.

Active or passive, in a control situation there should be a built-in profit. The sine qua non of this operation is an attractive purchase price. Once control is achieved, the value of our investment is determined by the value of the enterprise, not the oftentimes irrationalities of the market place.

Any of the three situations where we are now the largest stockholders mentioned under Generals - Private Owner could, by virtue of the two-way stretch they possess, turn into controls. That would suit us fine, but it also suits us if they advance in the market to a price more in line with intrinsic value enabling us to sell them, thereby completing a successful generals - private owner operation.

Investment results in the control category have to be measured on the basis of at least several years. Proper buying takes time. If needed, strengthening management, redirecting the utilization of capital, perhaps effecting a satisfactory sale or merger, etc., are also all factors that make this a business to be measured in years rather than months. For this reason, in controls, we are looking for wide margins of profit -if it appears at all close, we quitclaim.

Controls in the buying stage move largely in sympathy with the Dow. In the later stages their behavior is geared more to that of workouts.

You might be interested to know that the buyers of our former control situation, Dempster Mill Manufacturing, seem to be doing very well with it. This fulfills our expectation and is a source of satisfaction. An investment operation that depends on the ultimate buyer making a bum deal (in Wall Street they call this the "Bigger Fool Theory") is tenuous indeed. How much more satisfactory it is to buy at really bargain prices so that only an average disposition brings pleasant results.

As I have mentioned in the past, the division of our portfolio among categories is largely determined by the accident of availability. Therefore, in any given year the mix between generals, workouts, or controls is largely a matter of chance, and this fickle factor will have a great deal to do with our performance relative to the Dow. This is one of many reasons why single year's performance is of minor importance and good or bad, should never be taken too seriously.

To give an example of just how important the accident of division between these categories is, let me cite the example of the past three years. Using an entirely different method of calculation than that used to measure the performance of BPL in entirety, whereby the average monthly investment at market value by category is utilized, borrowed money and office operating expenses excluded, etc., (this gives the most accurate basis for intergroup comparisons but does not reflect overall BPL results) the generals (both present categories combined), workouts, and the Dow, shape up as follows:

Year	**Generals**	**Workouts**	**Dow**
1962	-1.0%	14.6%	-8.6%
1963	20.5%	30.6%	18.4%
1964	27.8%	10.3%	16.7%

Obviously the workouts (along with controls) saved the day in 1962, and if we had been light in this category that year, our final result would have been much poorer, although still quite respectable considering market conditions during the year. We could just as well have had a much smaller percentage of our portfolio in workouts that year; availability decided it, not any notion on my part as to what the market was going to do. Therefore, it is important to realize that in 1962 we were just plain lucky regarding mix of categories.

In 1963 we had one sensational workout which greatly influenced results, and generals gave a good account of themselves, resulting in a banner year. If workouts had been normal, (say, more like 1962) we would have looked much poorer compared to the Dow. Here it wasn't our mix that did much for us, but rather excellent situations.

Finally, in 1964 workouts were a big drag on performance. This would be normal in any event during a big plus year for the Dow such as 1964, but they were even a greater drag than expected because of mediocre experience. In retrospect it would have been pleasant to have been entirely in generals, but we don’t play the game in retrospect.

I hope the preceding table drives home the point that results in a given year are subject to many variables - some regarding which we have little control or insight. We consider all categories to be good businesses and we are very happy we have several to rely on rather than just one. It makes for more discrimination within each category and reduces the chance we will be put completely out of operation by the elimination of opportunities in a single category.

<u>Taxes</u>

We have had a chorus of groans this year regarding partners' tax liabilities. Of course, we also might have had a few if the tax sheet had gone out blank.

More investment sins are probably committed by otherwise quite intelligent people because of "tax considerations" than from any other cause. One of my friends - a noted West Coast philosopher maintains that a majority of life's errors are caused by forgetting what one is really trying to do. This is certainly the case when an emotionally supercharged element like taxes enters the picture (I have another friend -a noted East Coast philosopher who says it isn't the lack of representation he minds -it's the taxation).

Let's get back to the West Coast. What is one really trying to do in the investment world? Not pay the least taxes, although that may be a factor to be considered in achieving the end. Means and end should not be confused, however, and the end is to come away with the largest after-tax rate of compound. Quite obviously if two courses of action promise equal rates of pre-tax compound and one involves incurring taxes and the other doesn't the latter course is superior. However, we find this is rarely the case.

It is extremely improbable that 20 stocks selected from, say, 3000 choices are going to prove to be the optimum portfolio both now and a year from now at the entirely different prices (both for the selections and the alternatives) prevailing at that later date. If our objective is to produce the maximum after-tax compound rate, we simply have to own the most attractive securities obtainable at current prices, And, with 3,000 rather rapidly shifting variables, this must mean change (hopefully “tax-generating” change).

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.

If gains are involved, changing portfolios involves paying taxes. Except in very unusual cases (I will readily admit there are some cases), the amount of the tax is of minor importance if the difference in expectable performance is significant. I have never been able to understand why the tax comes as such a body blow to many people since the rate on long-term capital gain is lower than on most lines of endeavor (tax policy indicates digging ditches is regarded as socially less desirable than shuffling stock certificates).

I have a large percentage of pragmatists in the audience so I had better get off that idealistic kick. There are only three ways to avoid ultimately paying the tax: (1) die with the asset - and that's a little too ultimate for me even the zealots would have to view this "cure" with mixed emotions; (2) give the asset away - you certainly don't pay any taxes this way, but of course you don't pay for any groceries, rent, etc., either; and (3) lose back the gain if your mouth waters at this tax-saver, I have to admire you -you certainly have the courage of your convictions.

So it is going to continue to be the policy of BPL to try to maximize investment gains, not minimize taxes. We will do our level best to create the maximum revenue for the Treasury -at the lowest rates the rules will allow.

An interesting sidelight on this whole business of taxes, vis-à-vis investment management, has appeared in the last few years. This has arisen through the creation of so-called "swap funds" which are investment companies created by the exchange of the investment company's shares for general market securities held by potential investors. The dominant sales argument has been the deferment (deferment, when pronounced by an enthusiastic salesman, sometimes comes very close phonetically to elimination) of capital gains taxes while trading a single security for a diversified portfolio. The tax will only finally be paid when the swap fund's shares are redeemed. For the lucky ones, it will be avoided entirely when any of those delightful alternatives mentioned two paragraphs earlier eventuates.

The reasoning implicit in the swapee's action is rather interesting. He obviously doesn't really want to hold what he is holding or he wouldn't jump at the chance to swap it (and pay a fairly healthy commission - usually up to $100,000) for a grab-bag of similar hot potatoes held by other tax-numbed investors. In all fairness, I should point out that after all offerees have submitted their securities for exchange and had a chance to review the proposed portfolio they have a chance to back out but I understand a relatively small proportion do so.

There have been twelve such funds (that I know of) established since origination of the idea in 1960, and several more are currently in the works. The idea is not without appeal since sales totaled well over $600 million. All of the funds retain an investment manager to whom they usually pay 1/2 of 1% of asset value. This investment manager faces an interesting problem; he is paid to manage the fund intelligently (in each of the five largest funds this fee currently ranges from $250,000 to $700,000 per year), but because of the low tax basis inherited from the contributors of securities, virtually his every move creates capital gains tax liabilities. And, of course, he knows that if he incurs such liabilities, he is doing so for people who are probably quite sensitive to taxes or they wouldn't own shares in the swap fund in the first place.

I am putting all of this a bit strongly, and I am sure there are some cases where a swap fund may be the best answer to an individual's combined tax and investment problems. Nevertheless, I feel they offer a very interesting test-tube to measure the ability of some of the most respected investment advisors when they are trying to manage money without paying (significant) taxes.

The three largest swap funds were all organized in 1961, and combined have assets now of about $300 million. One of these, Diversification Fund, reports on a fiscal year basis which makes extraction of relevant data quite difficult for calendar year comparisons. The other two, Federal Street Fund and Westminster Fund (respectively first and third largest in the group) are managed by investment advisors who oversee at least $2 billion of institutional money.

Here's how they shape up for all full years of existence:

Year	Federal Street	Westminster	Dow
1962	-19.0%	-22.5%	-7.6%
1963	17.0%	18.7%	20.6%
1964	13.8%	12.3%	18.7%
Annual Compounded Rate	2.6%	1.1%	9.8%

This is strictly the management record. No allowance has been made for the commission in entering and any taxes paid by the fund on behalf of the shareholders have been added back to performance.

Anyone for taxes?

Miscellaneous

In the December 21st issue of AUTOMOTIVE NEWS it was reported that Ford Motor Co. plans to spend $700 million in 1965 to add 6,742,000 square feet to its facilities throughout the world. Buffett Partnership, Ltd., never far behind, plans to add 227 1/4 square feet to its facilities in the spring of 1965.

Our growth in net assets from $105,100 (there's no prize for guessing who put in the $100) on May 5, 1956 when the first predecessor limited partnership.(Buffett Associates, Ltd.) was organized, to $26,074,000 on 1/1/65 creates the need for an occasional reorganization in internal routine. Therefore, roughly contemporaneously with the bold move from 682 to 909 ¼ square feet, a highly capable is going to join our organization with responsibility for the administrative (and certain other) functions. This move will particularly serve to free up more of Bill Scott's time for security analysis which is his forte. I'll have more to report on this in the midyear letter.

Bill (who continues to do a terrific job) and his wife have an investment in the Partnership of $298,749, a very large majority of their net worth. Our new associate (his name is being withheld until his present employer has replaced him), along with his wife and children, has made an important investment in the Partnership. Susie and I presently have an interest of $3,406,700 in BPL which represents virtually our entire net worth, with the exception of our continued holding of Mid-Continent Tab Card Co., a local company into which I bought in 1960 when it had less than 10 stockholders. Additionally, my relatives, consisting of three children, mother , two sisters, two brothers-in-law, father-in-Law, four aunts, four cousins and six nieces and nephews, have interests in BPL, directly or indirectly, totaling $1,942,592. So we all continue to eat home cooking.

We continue to represent the ultimate in seasonal businesses --open one day a year. This creates real problems in keeping the paper flowing smoothly, but Beth and Donna continue to do an outstanding job of coping with this and other problems.

Peat, Marwick, Mitchell has distinguished itself in its usual vital role of finding out what belongs to whom. We continue to throw impossible deadlines at them --and they continue to perform magnificently. You will note in their certificate this year that they have implemented the new procedure whereby they now pounce on us unannounced twice a year in addition to the regular yearend effort.

Finally -and most sincerely -let me thank you partners who cooperate magnificently in getting things to us promptly and properly and thereby maximize the time we can spend working where we should be -by the cash register. I am extremely fortunate in being able to spend the great majority of my time thinking about where our money should be invested, rather than getting bogged down in the minutiae that seems to overwhelm so many business entities. We have an organizational structure which makes this efficiency a possibility, and more importantly, we have a group of partners that make it a reality. For this, I am most appreciative and we are all wealthier.

Our past policy has been to admit close relatives of present partners without a minimum capital limitation. This year a flood of children, grandchildren, etc., appeared which called this policy into question; therefore, I have decided to institute a $25,000 minimum on interests of immediate relatives of present partners.

Within the coming two weeks you will receive:

(1) A tax letter giving you all BPL information needed for your 1964 federal income tax return. This letter is the only item that counts for tax purposes.

(2) An audit from Peat, Marwick, Mitchell & Co. for 1964, setting forth the operations and financial position of BPL as well as your own capital account.

(3) A letter signed by me setting forth the status of your BPL interest on 111165. This is identical with the figure developed in the audit.

(4) Schedule “A” to the partnership agreement listing all partners.

Let Bill or me know if anything needs clarifying. Even with our splendid staff our growth means there is more chance of missing letters, overlooked instructions, a name skipped over, a figure transposition, etc., so speak up if you have any question at all that we might have erred. My next letter will be about July 15th" summarizing the first half of this year.

Cordially,

Warren E. Buffett

BUFFETT PARTNERSHIP, LTD.
810 KIEWIT PLAZA
OMAHA 31, NEBRASKA

July 9, 1965

Warren E. Buffett, General Partner
William Scott
John M. Harding

First Half Performance:

During the first half of 1965, the Dow Jones Industrial Average (hereinafter call the "Dow") declined from 874.13 to 868.03. This minor change was accomplished in a decidedly non-Euclidian manner. The Dow instead took the scenic route, reaching a high of 939.62 on May 14th. Adding back dividends on the Dow of 13.49 gives an overall gain through ownership of the Dow for the first half of 7.39 or 0.8%.

We had one of our better periods with an overall gain, before allocation to the general partner, of 10.4% or a 9.6 percentage point advantage over the Dow. To bring the record up to date, the following summarizes the year-by-year performance of the Dow, the performance of the Partnership before allocation to the general partner, and the limited partners' results:

Year	**Overall Results From Dow (1)**	**Partnership Results (2)**	**Limited Partners' Results (3)**
1957	-8.4%	10.4%	9.3%
1958	38.5%	40.9%	32.2%
1959	20.0%	25.9%	20.9%
1960	-6.2%	22.8%	18.6%
1961	22.4%	45.9%	35.9%
1962	-7.6%	13.9%	11.9%
1963	20.6%	38.7%	30.5%
1964	18.7%	27.8%	22.3%
1st half 1965	0.8%	10.4%	9.3%
Cumulative results	**133.2%**	**682.4%**	**449.7%**
Annual compounded rate	**10.5%**	**27.4%**	**22.2%**

(1) Based on yearly changes in the value of the Dow plus dividends that would have been received through ownership of the Dow during that year. The table includes all complete years of partnership activity.
(2) For 1957-61 consists of combined results of all predecessor limited partnerships operating throughout the entire year after all expenses but before distributions to partners or allocations to the general partner.
(3) For 1957-61 computed on the basis of the preceding column of partnership results allowing for allocation to the general partner based upon the present partnership agreement, but before monthly withdrawals by limited partners.

Our constant admonitions have been: (1) that short-term results (less than three years) have little meaning, particularly in reference to an investment operation such as ours that may devote a portion of resources to control situations; and, (2) that our results, relative to the Dow and other common-stock-form media usually will be better in declining markets and may well have a difficult time just matching such media in very strong markets.

With the latter point in mind, it might be imagined that we struggled during the first four months of the half to stay even with the Dow and then opened up our margin as it declined in May and June. Just the opposite occurred. We actually achieved a wide margin during the upswing and then fell at a rate fully equal to the Dow during the market decline.

I don't mention this because I am proud of such performance – on the contrary, I would prefer it if we had achieved our gain in the hypothesized manner. Rather, I mention it for two reasons: (1) you are always entitled to know when I am wrong as well as right; and, (2) it demonstrates that although we deal with probabilities and expectations, the actual results can deviate substantially from such expectations, particularly on a short-term basis. As mentioned in the most recent annual letter, our long-term goal is to achieve a ten percentage point per annum advantage over the Dow. Our advantage of 9.6 points achieved during the first six months must be regarded as substantially above average. The fortitude demonstrated by our partners in tolerating such favorable variations is commendable. We shall most certainly encounter periods when the variations are in the other direction.

During the first half, a series of purchases resulted in the acquisition of a controlling interest in one of the situations described in the "General Private Owner" section of the last annual letter. When such a controlling interest is acquired, the assets and earning power of the business become the immediate predominant factors in 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.

When a controlling interest is held, we own a business rather then a stock, and a business valuation is appropriate. We have carried our controlling position at a conservative valuation at midyear and will reevaluate it in terms of assets and earning power at yearend. The annual letter, issued in January, 1966, will carry a full story on this current control situation. At this time it is enough to say that we are delighted with both the acquisition cost and the business operation, and even happier about the people we have managing the business.

<u>Investment Companies:</u>

We regularly compare our results with the two largest open-end investment companies (mutual funds) that follow a policy of being, typically, 95-100% invested in common stocks, and the two largest diversified closed-end investment companies. These four companies, Massachusetts Investors Trust, Investors Stock Fund, Tri-Continental Corp., and Lehman Corp., manage over $4 billion and are probably typical of most of the $30 billion investment company industry. Their results are shown in the following table. My opinion is that this performance roughly parallels that of the overwhelming majority of other investment advisory organizations which handle, in aggregate, vastly greater sums.

Year	**Mass. Inv. Trust (1)**	**Investors Stock (1)**	**Lehman (2)**	**Tri-Cont (2)**	**Dow**	**Limited Partners**
1957	-11.4%	-12.4%	-11.4%	-2.4%	-8.4%	9.3%
1958	42.7	47.5	40.8	33.2	38.5	32.2
1959	9.0	10.3	8.1	8.4	20.0	20.9
1960	-1.0	-0.6	2.5	2.8	-6.2	18.6
1961	25.6	24.9	23.6	22.5	22.4	35.9
1962	-9.8	-13.4	-14.4	-10.0	-7.6	11.9
1963	20.0	16.5	23.7	18.7	20.6	30.5
1964	15.9	14.3	14.0	13.6	18.7	22.3
1st half 1965	0.0	-0.6	2.7	0.0	0.8	9.3

Cumulative Results	114.9	102.8	111.7	115.4	133.2	449.7
Annual Compounded Rate	9.4	8.7	9.2	9.5	10.5	22.2

(1) Computed from changes in asset value plus any distributions to holders of record during year.
(2) From 1965 Moody's Bank & Finance Manual for 1957-64. Estimated for first half 1965.

Last year I mentioned that the performance of these companies in some ways resembles the activity of a duck sitting on a pond. When the water (the market) rises, the duck rises; when if falls, back goes the duck. The water level was virtually unchanged during the first half of 1965. The ducks, as you can see from the table, are still sitting on the pond.

As I mentioned earlier in the letter, the ebb of the tide in May and June also substantially affected us. Nevertheless, the fact we had flapped our wings a few times in the preceding four months enabled us to gain a little altitude on the rest of the flock. Utilizing a somewhat more restrained lexicon, James H. Lorie, director of the University of Chicago's Center for Research in Security Prices was quoted in the May 25, 1965, WALL STREET JOURNAL as saying: "There is no evidence that mutual funds select stocks better than by the random method."

Of course, the beauty of the American economic scene has been that random results have been pretty darned good results. The water level has been rising. In our opinion, the probabilities are that over a long period of time, it will continue to rise, though, certainly not without important interruptions. It will be our policy, however, to endeavor to swim strongly, with or against the tide. If our performance declines to a level you can achieve by floating on your back, we will turn in our suits.

Advance Payments and Advance Withdrawals:

We accept advance payments from partners and prospective partners at 6% interest from date of receipt until the end of the year. While there is no obligation to convert such advance payments to a partnership interest at the end of the year, this should be the intent at the time it is paid to us.

Similarly, we allow partners to withdraw up to 20% of their partnership account prior to yearend and charge them 6% from date of withdrawal until yearend when it is charged against their capital account. Again, it is not intended that partners use us like a bank, but that they use the withdrawal right for a truly unexpected need for funds. Predictable needs for funds such as quarterly federal tax payments should be handled by a beginning-of-the-year reduction in capital rather than through advance withdrawals from B.P.L. during the year. The withdrawal privilege is to provide for the unanticipated.

The willingness to borrow (through advance payments) and lend (through advance withdrawals) at the same 6% rate may sound downright "un-Buffettlike". (You can be sure it doesn't start my adrenaline flowing.) Certainly such a no-spread arbitrage is devoid of the commercial overtones an observer might impute to the preponderance of our transactions. Nevertheless, we think it makes sense and is in the best interest of all partners.

The partner who has a large investment in indirect ownership of a group of liquid assets should have some liquidity present in his partnership interest other than at yearend. As a practical matter, we are reasonably certain that advance withdrawals will be far more than covered by advance payments. For example, on June 30, 1965, we had $98,851 of advance withdrawals and $652,931 of advance payments.

Why then the willingness to pay 6% for the net of advance payments over advance withdrawals when we can borrow from commercial banks at substantially lower rates? The answer is that we expect on a long-term basis to earn better than 6% (the general partner's allocation is zero unless we do) although it is largely a matter of chance whether we achieve the 6% figure in any short period. Moreover, I can adopt a different attitude regarding the investment of money that can be expected to soon be a part of our equity capital than I can on short-term borrowed money. The advance payments have the added advantage to us of spreading the investment of new money over the year, rather than having it hit us all at once in January. On the other hand, 6% is more than can be obtained in short-term dollar secure investments by our partners, so I consider it mutually profitable.

Miscellaneous:

The bold expansion program to 909 ¼ square feet described in the annual letter was carried off without a hitch (the Pepsi's never even got warm).

John Harding joined us in April and is continuing the record whereby all the actions in the personnel field have been winning ones.

As in past years, we will have a letter out about November 1st (to partners and those who have indicated an interest to me by that time in becoming partners) with the commitment letter for 1966, estimate of the 1965 tax situation, etc.

Cordially,
Warren E. Buffett

BUFFETT PARTNERSHIP, LTD.
810 KIEWIT PLAZA
OMAHA 31, NEBRASKA

November 1, 1965

To My Partners for 1966:

Enclosed are:

(1) Two copies or the commitment letter for 1966, one to be kept by you and one returned to us. You may amend the commitment letter right up to midnight, December 31st. So get it back to us early, and if it needs to be changed, just let us know by letter or phone. Commitment letters become final on December 31st. Every year I get a number or calls in the first week in January expressing a desire to add to the January 1st capital. THIS CAN'T BE DONE.

(2) A copy of our ever-popular "The Ground Rules." It is essential that we see eye-to-eye on the matters covered therein. If you have different views - fine, yours may be better - but you shouldn't be in the partnership. Please particularly note Ground Rule 7. This has been added this year reflecting a moderate shift in my attitude over a period of time. It represents a decidedly unconventional (but logical in my opinion when applied to our operation) approach and is therefore specifically called to your attention.

Any withdrawals will be paid January 5th. You may withdraw any amount you desire from $100 up to your entire equity. Similarly, additions can be for any amount and should reach us by January 10th. In the event you are disposing of anything, this will give you a chance to have the transaction in 1966 if that appears to be advantageous for tax reasons. If additions reach us in November, they take on the status of advance payments and draw 6% interest until yearend. This is not true of additions reaching us in December.

The partnership owns a controlling interest in Berkshire Hathaway Inc., a publicly-traded security. As mentioned in my midyear letter, asset values and earning power are the dominant factors affecting the valuation of a controlling interest in a business. Market price, which governs valuation of minority interest positions, is of little or no importance in valuing a controlling interest. We will value our position in Berkshire Hathaway at yearend at a price halfway between net current asset value and book value. Because of the nature of our receivables and inventory this, in effect, amounts to valuation of our current assets at 100 cents on the dollar and our fixed assets at 50 cents on the dollar. Such a value in my opinion is fair to both adding and withdrawing partners. It may be either of lower than market value at the time.

As I write this, we are orbiting in quite satisfactory fashion. Our margin over the Dow is well above average, and even those Neanderthal partners who utilize such crude yardsticks as net profit would find performance satisfactory. This is all, of course, subject to substantial change by yearend.

If anything needs clarification, call or write John Harding who is in charge of "de-confusing" partners. The tax situation is about as reported in the August letter, but if you would like John to make the calculation for you, he will be glad to do it.

Cordially,

Warren E. Buffett

P/S: We are continuing our "no prize" policy for the last ones to get their commitment letters back to us. It will make things easier for us if you get it back pronto. If you want to make changes later (before January lst), just give us a call, and we'll amend it for you.

BUFFETT PARTNERSHIP, LTD.
810 KIEWIT PLAZA
OMAHA 31, NEBRASKA

January 20, 1966

Our Performance in 1965

Our War on Poverty was successful in 1965.

Specially, we were $12,304,060 less poor at the end of the year.

Last year under a section in the annual letter entitled "Our Goal" (please particularly note it was not headed "Our Promise"), I stated we were trying to achieve "… An average advantage (relative to the Dow) of ten percentage points per annum for BPL before allocation to the general partner again with large amplitudes in the margin from perhaps 10 percentage points worse than the Dow in a bad year to 25 percentage points better when everything clicks."

My fallibility as a forecaster was quickly demonstrated when the first year fell outside my parameters. We achieved our widest margin over the Dow in the history of BPL with an overall gain of 47.2% compared to an overall gain (including dividends which would have been received through ownership of the Dow) of 14.2% for the Dow. Naturally, no writer likes to be publicly humiliated by such a mistake. It is unlikely to be repeated.

The following summarizes the year-by-year performance of the Dow, the performance of the Partnership before allocation (one quarter of the excess over 6%) to the general partner, and the results for limited partners:

Year	**Overall Results From Dow (1)**	**Partnership Results (2)**	**Limited Partners' Results (3)**
1957	-8.4%	10.4%	9.3%
1958	38.5%	40.9%	32.2%
1959	20.0%	25.9%	20.9%
1960	-6.2%	22.8%	18.6%
1961	22.4%	45.9%	35.9%
1962	-7.6%	13.9%	11.9%
1963	20.6%	38.7%	30.5%
1964	18.7%	27.8%	22.3%
1965	14.2%	47.2%	36.9%

(1) Based on yearly changes in the value of the Dow plus dividends that would have been received through ownership of the Dow during that year. The table includes all complete years of partnership activity.

(2) For 1957-61 consists of combined results of all predecessor limited partnerships operating throughout the entire year after all expenses, but before distributions to partners or allocations to the general partner.

(3) For 1957-61 computed on the basis of the preceding column of partnership results allowing for allocation to the general partner based upon the present partnership agreement, but before monthly withdrawals by limited partners.

On a cumulative or compounded basis, the results are:

Year	Overall Results From Dow	Partnership Results	Limited Partners' Results
1957	-8.4%	10.4%	9.3%
1957 – 58	26.9%	55.6%	44.5%
1957 – 59	52.3%	95.9%	74.7%
1957 – 60	42.9%	140.6%	107.2%
1957 – 61	74.9%	251.0%	181.6%
1957 – 62	61.6%	299.8%	215.1%
1957 – 63	95.1%	454.5%	311.2%
1957 – 64	131.3%	608.7%	402.9%
1957 – 65	164.1%	943.2%	588.5%
Annual Compounded Rate	**11.4%**	**29.8%**	**23.9%**

After last year the question naturally arises, "What do we do for an encore?" A disadvantage of this business is that it does not possess momentum to any significant degree. If General Motors accounts for 54% of domestic new car registrations in 1965, it is a pretty safe bet that they are going to come fairly close to that figure in 1966 due to owner loyalties, dealer capabilities, productive capacity, consumer image, etc. Not so for BPL. We start from scratch each year with everything valued at market when the gun goes off. Partners in 1966, new or old, benefit to only a very limited extent from the efforts of 1964 and 1965. The success of past methods and ideas does not transfer forward to future ones.

I continue to hope, on a longer-range basis, for the sort of achievement outlined in the "Our Goal" section of last year's letter (copies still available). However, those who believe 1965 results can be achieved with any frequency are probably attending weekly meetings of the Halley's Comet Observers Club. We are going to have loss years and are going to have years inferior to the Dow - no doubt about it. But I continue to believe we can achieve average performance superior to the Dow in the future. If my expectation regarding this should change, you will hear immediately.

Investment Companies

We regularly compare our results with the two largest open-end investment companies (mutual funds) that follow a policy of being typically 95% - 100% invested in common stocks, and the two largest diversified closed-end investment companies. These four companies, Massachusetts Investors Trust, Investors Stock Fund, Tri-Continental Corp., and Lehman Corp. manage over $5 billion, are owned by about 600,000 shareholders, and are probably typical of most of the $35 billion investment company industry. My opinion is that their results roughly parallel those of the overwhelming majority of other investment advisory organizations which handle, in aggregate, vastly greater sums.

The purpose of this tabulation is to illustrate that the Dow is no pushover as an index of investment achievement. The advisory talent managing just the four companies shown commands annual fees of about $10 million and this represents a very small fraction of the professional investment management industry. The public batting average of this highly paid and widely respected talent indicates performance a shade below that of the Dow, an unmanaged index.

YEARLY RESULTS

Year	Mass. Inv.	Investors	Lehman (2)	Tri-Cont	Dow	Limited

	Trust (1)	Stock (1)		(2)		Partners
1957	-11.4%	-12.4%	-11.4%	-2.4%	-8.4%	9.3%
1958	42.7%	47.5%	40.8%	33.2%	38.5%	32.2%
1959	9.0%	10.3%	8.1%	8.4%	20.0%	20.9%
1960	-1.0%	-0.6%	2.5%	2.8%	-6.2%	18.6%
1961	25.6%	24.9%	23.6%	22.5%	22.4%	35.9%
1962	-9.8%	-13.4%	-14.4%	-10.0%	-7.6%	11.9%
1963	20.0%	16.5%	23.7%	18.3%	20.6%	30.5%
1964	15.9%	14.3%	13.6%	12.6%	18.7%	22.3%
1965	10.2%	9.8%	19.0%	10.7%	14.2%	36.9%

(1) Computed from changes in asset value plus any distributions to holders of record during year.
(2) From 1965 Moody's Bank & Finance Manual for 1957-64. Estimated for 1965.

COMPOUNDED

Year	**Mass. Inv. Trust (1)**	**Investors Stock (1)**	**Lehman (2)**	**Tri-Cont (2)**	**Dow**	**Limited Partners**
1957	-11.4%	-12.4%	-11.4%	-2.4%	-8.4%	9.3%
1957 – 58	26.4%	29.2%	24.7%	30.0%	26.9%	44.5%
1957 – 59	37.8%	42.5%	34.8%	40.9%	52.3%	74.7%
1957 – 60	36.4%	41.6%	38.2%	44.8%	42.9%	107.2%
1957 – 61	71.3%	76.9%	70.8%	77.4%	74.9%	181.6%
1957 – 62	54.5%	53.2%	46.2%	59.7%	61.6%	215.1%
1957 – 63	85.4%	78.5%	80.8%	88.9%	94.9%	311.2%
1957 – 64	114.9%	104.0%	105.4%	112.7%	131.3%	402.9%
1957 – 65	136.8%	124.0%	145.3%	138.4%	164.1%	588.5%
Annual Compounded Rate	**10.1%**	**9.4%**	**10.5%**	**10.1%**	**11.4%**	**23.9%**

A number of the largest investment advisory operations (managing, in some cases, well into the billions of dollars) also manage investment companies partly as a convenience for smaller clients and partly as a public showcase. The results of these funds roughly parallel those of the four funds on which we report.

I strongly believe in measurement. The investment managers mentioned above utilize measurement constantly in their activities. They constantly study changes in market shares, profit margins, return on capital, etc. Their entire decision-making process is geared to measurement - of managements, industries, comparative yields, etc. I am sure they keep score on their new business efforts as well as the profitability of their advisory operation. What then can be more fundamental than the measurement, in turn, of investment ideas and decisions? I certainly do not believe the standards I utilize (and wish my partners to utilize) in measuring my performance are the applicable ones for all money managers. But I certainly do believe anyone engaged in the management of money should have a standard of measurement, and that both he and the party whose money is managed should have a clear understanding why it is the appropriate standard, what time period should be utilized, etc.

Frank Block put it very well in the November-December 1965 issue of the Financial Analysts Journal. Speaking of measurement of investment performance he said," ...However, the fact is that literature suffers a yawning hiatus in this subject. If investment management organizations sought always the best performance, there would be nothing unique in careful measurement of investment results. It does not matter that the customer has failed to ask for a formal presentation of the results. Pride alone should be sufficient to demand that each or us determine objectively the quality of his recommendations. This can hardly be done without precise knowledge of the outcome. Once this knowledge is in hand, it should be possible to extend the analysis to some point at which patterns of weakness and strength begin to assert themselves. We criticize a corporate management for failure to use the best of tools to keep it aware of the progress of a complicated industrial organization. We can hardly be excused for failure to provide ourselves with equal tools to show the efficiency of our own efforts to handle other people's money. ...Thus, it is our dreary duty to report that systems of performance measurement are not automatically included in the data processing programs of most investment management organizations. The sad fact is that some seem to prefer not to know how well or poorly they are doing.

Frankly, I have several selfish reasons for insisting that we apply a yardstick and that we both utilize the same yardstick. Naturally, I get a kick out of beating par - in the lyrical words of Casey Stengel, "Show me a good loser, and I'll show you a loser." More importantly, I insure that I will not get blamed for the wrong reason (having losing years) but only for the right reason (doing poorer than the Dow). Knowing partners will grade me on the right basis helps me do a better job. Finally, setting up the relevant yardsticks ahead of time insures that we will all get out of this business if the results become mediocre (or worse). It means that past successes cannot cloud judgment of current results. It should reduce the chance of ingenious rationalizations of inept performance. (Bad lighting has been bothering me at the bridge table lately.) While this masochistic approach to measurement may not sound like much of an advantage, I can assure you from my observations of business entities that such evaluation would have accomplished a great deal in many investment and industrial organizations.

So if you are evaluating others (or yourself!) in the investment field, think out some standards - apply them - interpret them. If you do not feel our standard (a minimum of a three-year test versus the Dow) is an applicable one, you should not be in the Partnership. If you do feel it is applicable, you should be able to take the minus years with equanimity in the visceral regions as well as the cerebral regions -as long as we are surpassing the results of the Dow.

<u>The Sorrows of Compounding</u>

Usually, at this point in my letter, I have paused to modestly attempt to set straight the historical errors of the last four or five hundred years. While it might seem difficult to accomplish this in only a few paragraphs a year, I feel I have done my share to reshape world opinion on Columbus, Isabella, Francis I, Peter Minuit and the Manhattan Indians. A by-product of this endeavor has been to demonstrate the overwhelming power of compound interest. To insure reader attention I have entitled these essays "The Joys of Compounding. " The sharp-eyed may notice a slight change this year.

A decent rate (better we have an indecent rate) of compound -plus the addition of substantial new money has brought our beginning capital this year to $43,645,000. Several times in the past I have raised the question whether increasing amounts of capital would harm our investment performance. Each time I have answered negatively and promised you that if my opinion changed, I would promptly report it.

I do not feel that increased capital has hurt our operation to date. As a matter of fact, I believe that we have done somewhat better during the past few years with the capital we have had in the Partnership than we would have done if we had been working with a substantially smaller amount. This was due to the partly fortuitous development of several investments that were just the right size for us -big enough to be significant and small enough to handle.

I now feel that we are much closer to the point where increased size may prove disadvantageous. I don't want to ascribe too much precision to that statement since there are many variables involved. What may be the optimum size under some market and business circumstances can be substantially more or less than optimum under other circumstances. There have been a few times in the past when on a very short-term basis I have felt it would have been advantageous to be smaller but substantially more times when the converse was true.

Nevertheless, as circumstances presently appear, I feel substantially greater size is more likely to harm future results than to help them. This might not be true for my own personal results, but it is likely to be true for your results.

Therefore, unless it appears that circumstances have changed (under some conditions added capital would improve results) or unless new partners can bring some asset to the Partnership other than simply capital, I intend to admit no additional partners to BPL.

The only way to make this effective is to apply it across-the-board and I have notified Susie that if we have any more children, it is up to her to find some other partnership for them.

Because I anticipate that withdrawals (for taxes, among other reasons) may well approach additions by present partners and also because I visualize the curve of expectable performance sloping only very mildly as capital increases, I presently see no reason why we should restrict capital additions by existing partners.

The medically oriented probably will interpret this entire section as conclusive evidence that an effective antithyroid pill has been developed.

Trends in Our Business

Last year I discussed our various categories of investments. Knowing the penalties for cruel and unusual punishments, I will skip a rehash of the characteristics of each category, but merely refer you to last year's letter. However, a few words should be said to bring you up to date on the various segments of the business, and perhaps to give you a better insight into their strengths and weaknesses.

The "Workout" business has become very spasmodic. We were able to employ an average of only about $6 million during the year in the Workout section, and this involved only a very limited number of situations. Although we earned about $1,410,000 or about 23 ½% on average capital employed (this is calculated on an all equity basis - borrowed money is appropriate in most Workout situations, and we utilize it, which improves our rate of return above this percentage), over half of this was earned from one situation. I think it unlikely that a really interesting rate of return can be earned consistently on large sums of money in this business under present conditions. Nevertheless, we will continue to try to remain alert for the occasional important opportunity and probably continue to utilize a few of the smaller opportunities where we like the probabilities.

The "Generals-Private Owner Basis" category was very good to us in 1965. Opportunities in this area have become more scarce with a rising Dow, but when they come along, they are often quite significant. I mentioned at the start of last year that we were the largest stockholder of three companies in this category. Our largest yearend 1964 investment in this category was disposed of in 1965 pursuant to a tender offer resulting in a realized gain for BPL of $3,188,000. At yearend 1964 we had unrealized appreciation in this investment of $451,000. Therefore, the economic gain attributable to 1965 for this transaction was only $2,737,000 even though the entire tax effect fell in that year. I mention these figures to illustrate how our realized gain for tax purposes in any year bears no necessary relationship to our economic gain.

The fundamental concept underlying the Generals-Private Owner category is demonstrated by the above case. A private owner was quite willing (and in our opinion quite wise) to pay a price for control of the business which isolated stock buyers were not willing to pay for very small fractions of the business. This has been a quite common condition in the securities markets over many years, and although purchases in this category work out satisfactorily in terms of just general stock market behavior, there is the occasional dramatic profit due to corporate action such as the one above.

The "Control" section of our business received a transfer member from our “Private Owner” category. Shares in Berkshire Hathaway had been acquired since November 1962 on much the same line of reasoning as prevailed in the security mentioned above. In the case of Berkshire, however, we ended up purchasing enough stock to assume a controlling position ourselves rather than the more usual case of either selling our stock in the market or to another single buyer.

Our purchases of Berkshire started at a price of $7.60 per share in 1962. This price partially reflected large losses incurred by the prior management in closing some of the mills made obsolete by changing conditions within the textile business (which the old management had been quite slow to recognize). In the postwar period the company had slid downhill a considerable distance, having hit a peak in 1948 when about $29 1/2 million was earned before tax and about 11,000 workers were employed. This reflected output from 11 mills.

At the time we acquired control in spring of 1965, Berkshire was down to two mills and about 2,300 employees. It was a very pleasant surprise to find that the remaining units had excellent management personnel, and we have not had to bring a single man from the outside into the operation. In relation to our beginning acquisition cost of $7.60 per share (the average cost, however, was $14.86 per share, reflecting very heavy purchases in early 1965), the company on December 31, 1965, had net working capital alone (before placing any value on the plants and equipment) of about $19 per share.

Berkshire is a delight to own. There is no question that the state of the textile industry is the dominant factor in determining the earning power of the business, but we are most fortunate to have Ken Chace running the business in a first-class manner, and we also have several of the best sales people in the business heading up this end of their respective divisions.

While a Berkshire is hardly going to be as profitable as a Xerox, Fairchild Camera or National Video in a hypertensed market, it is a very comfort able sort of thing to own. As my West Coast philosopher says, “It is well to have a diet consisting of oatmeal as well as cream puffs.”

Because of our controlling interest, our investment in Berkshire is valued for our audit as a business, not as a marketable security. If Berkshire advances $5 per share in the market, it does BPL no good - our holdings are not going to be sold. Similarly, if it goes down $5 per share, it is not meaningful to us. The value of our holding is determined directly by the value of the business. I received no divine inspiration in that valuation of our holdings. (Maybe the owners of the three wonder stocks mentioned above do receive such a message in respect 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 seller of the other items in our portfolio at yearend valuations –otherwise, we would already have sold them.

Our final category is "Generals-Relatively Undervalued.” This category has been growing in relative importance as opportunities in the other categories become less frequent.

Frankly, operating in this field is somewhat more ethereal than operating in the other three categories, and I'm just not an ethereal sort. Therefore, I feel accomplishments here are less solid and perhaps less meaningful for future projections than in the other categories. Nevertheless, our results in 1965 were quite good in the “Relatively Undervalued” group, partly due to implementation of the technique referred to in last year's letter which serves to reduce risk and potentially augment gains. It should reduce risk in any year, and it definitely augmented the gains in 1965. It is necessary to point out that results in this category were greatly affected for the better by only two investments.

Candor also demands I point out that during 1965 we had our worst single investment experience in the history of BPL on one idea in this group.

Overall, we had more than our share of good breaks in 1965. We did not have a great quantity of ideas, but the quality, with the one important exception mentioned above, was very good and circumstances developed which accelerated the timetable in several. I do not have a great flood of good ideas as I go into 1966, although again I believe I have at least several potentially good ideas of substantial size. Much depends on whether market conditions are favorable for obtaining a larger position.

All in all, however, you should recognize that more came out of the pipeline in 1965 than went in.

Diversification

Last year in commenting on the inability of the overwhelming majority of investment managers to achieve performance superior to that of pure chance, I ascribed it primarily to 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."

This year in the material which went out in November, I specifically called your attention to a new Ground Rule 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."

We are obviously following a policy regarding diversification which differs markedly from that of practically all public investment operations. Frankly, there is nothing I would like better than to have 50 different investment opportunities, all of which have a mathematical expectation (this term reflects the range of all possible relative performances, including negative ones, adjusted for the probability of each - no yawning, please) of achieving performance surpassing the Dow by, say, fifteen percentage points per annum. If the fifty individual expectations were not intercorelated (what happens to one is associated with what happens to the other) I could put 2% of our capital into each one and sit back with a very high degree of certainty that our overall results would be very close to such a fifteen percentage point advantage.

It doesn't work that way.

We have to work extremely hard to find just a very few attractive investment situations. Such a situation by definition is one where my expectation (defined as above) of performance is at least ten percentage points per annum superior to the Dow. Among the few we do find, the expectations vary substantially. The question 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.

The above may make the whole operation sound very precise. It isn't. Nevertheless, our business is that of ascertaining facts and then applying experience and reason to such facts to reach expectations. Imprecise and emotionally influenced as our attempts may be, that is what the business is all about. The results of many years of decision-making in securities will demonstrate how well you are doing on making such calculations - whether 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.

There is one thing of which I can assure you. If good performance of the fund is even a minor objective, any portfolio encompassing one hundred stocks (whether the manager is handling one thousand dollars or one billion dollars) is not being operated logically. The addition of the one hundredth stock simply can't reduce the potential variance in portfolio performance sufficiently to compensate for the negative effect its inclusion has on the overall portfolio expectation.

Anyone owning such numbers of securities after presumably studying their investment merit (and I don't care how prestigious their labels) is following what I call the Noah School of Investing - two of everything. Such investors should be piloting arks. While Noah may have been acting in accord with certain time-tested biological principles, the investors have left the track regarding mathematical principles. (I only made it through plane geometry, but with one exception, I have carefully screened out the mathematicians from our Partnership.)

Of course, the fact that someone else is behaving illogically in owning one hundred securities doesn't prove our case. While they may be wrong in overdiversifying, we have to affirmatively reason through a proper diversification policy in terms of our objectives.

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.

I am willing to give up quite a bit in terms of leveling of year-to-year results (remember when I talk of “results,” I am talking of performance relative to the Dow) in order to achieve better overall long-term performance. Simply stated, this means I am willing to concentrate quite heavily in what I believe to be the best investment opportunities recognizing very well that this may cause an occasional very sour year - one somewhat more sour, probably, than if I had diversified more. While this means our results will bounce around more, I think it also means that our long-term margin of superiority should be greater.

You have already seen some examples of this. Our margin versus the Dow has ranged from 2.4 percentage points in 1958 to 33.0 points in 1965. If you check this against the deviations of the funds listed on page three, you will find our variations have a much wider amplitude. I could have operated in such a manner as to reduce our amplitude, but I would also have reduced our overall performance somewhat although it still would have substantially exceeded that of the investment companies. Looking back, and continuing to think this problem through, I feel that if anything, I should have concentrated slightly more than I have in the past. Hence, the new Ground Rule and this long-winded explanation.

Again let me state that this is somewhat unconventional reasoning (this doesn't make it right or wrong - it does mean you have to do your own thinking on it), and you may well have a different opinion - if you do, the 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 relative to the Dow compared to other opportunities available at the time. They are also going to have to possess such superior qualitative and/or quantitative factors that the chance of serious permanent loss is minimal (anything can happen on a short-term quotational basis which partially explains the greater risk of widened year-to-year variation in results). In selecting the limit to which I will go in anyone investment, I attempt to reduce to a tiny figure the probability that the single investment (or group, if there is intercorrelation) can produce a result for our total portfolio that would be more than ten percentage points poorer than the Dow.

We presently have two situations in the over 25% category - one a controlled company, and the other a large company where we will never take an active part. It is worth pointing out that our performance in 1965 was overwhelmingly the product of five investment situations. The 1965 gains (in some cases there were also gains applicable to the same holding in prior years) from these situations ranged from about $800,000 to about $3 1/2 million. If you should take the overall performance of our five smallest general investments in 1965, the results are lackluster (I chose a very charitable adjective).

Interestingly enough, the literature of investment management is virtually devoid of material relative to deductive calculation of optimal diversification.
All texts counsel "adequate" diversification, but the ones who quantify "adequate" virtually never explain how they arrive at their conclusion. Hence, for our summation on overdiversification, we turn to that eminent academician Billy Rose, who says, "You've got a harem of seventy girls; you don't get to know any of them very well."

<u>Miscellaneous</u>

Last year we boldly announced an expansion move, encompassing an additional 227 1/4 square feet. Older partners shook their heads. I feel that our gain from operations in 1965 of $12,304,060 indicates that we did not overextend ourselves. Fortunately, we didn't sign a percentage lease. Operationally, things have never been running more smoothly, and I think our present setup unquestionably lets me devote a higher percentage of my time to thinking about the investment process than virtually anyone else in the money management business. This, of course, is the result of really outstanding personnel and cooperative partners.

John Harding has taken complete charge of all administrative operations with splendid results. Bill Scott continues to develop detailed information on investments which substantially enhances our net profit figure. Beth Feehan, Donna Walter and Elizabeth Hanon (who joined us in November) have all handled large work loads (secretary's note -Amen!) accurately and efficiently.

The above people, their spouses (one apiece) and children have a combined investment in the Partnership of over $600,000. Susie and I have an investment of $6,849,936, which should keep me from slipping away to the movies in the afternoon. This represents virtually our entire net worth, with the exception of our continued holding of Mid-Continent Tab Card, a local company into which I bought in 1960 when it had less than 10 stockholders.

Additionally, my relatives, consisting of three children, mother, two sisters, two brothers-in-law, father-in-law, three aunts, two uncles, five cousins, and six nieces and nephews have interests in BPL, directly or indirectly, totaling $2,708,233. So don't get any ideas about voting a change in the Partnership name.

Peat, Marwick, Mitchell & Co. has done the customary excellent job of expediting the audit and tax information. This requires great effort and ability, and they supply both. This year a computer was brought to bear on our problems, and naturally, I was a little worried someone else would come out as the general partner. However, it all worked quite smoothly.

Within the coming two weeks you will receive:

1. A tax letter giving you all BPL information needed for your 1965 federal income tax return. This letter is the only item that counts for tax purposes.

2. An audit from Peat, Marwick, Mitchell & Co. for 1965, setting forth the operations and financial

position of BPL, as well as your own capital account.

3. A letter signed by me setting forth the status of your BPL interest on 1/1/66. This is identical with the figures developed in the audit.

Let me know if anything in this letter or that occurs during the year needs clarifying. It is difficult to anticipate all of the questions you may have and if there is anything that is confusing, I want to hear about it. For instance, we received an excellent suggestion last year from a partner regarding the presentation of the reconciliation of personal capital accounts.

My next letter will be about July 15th, summarizing the first ha1f of this year.

Cordially,

Warren E. Buffett

BUFFETT PARTNERSHIP. LTD.
610 KIEWIT PLAZA
OMAHA, NEBRASKA 68131
TELEPHONE 042-4110

July 12, 1966

First Half Performance

During the first half of 1966, the Dow-Jones Industrial Average (hereinafter called the "Dow") declined from 969.26 to 870.10. If one had owned the Dow during this period, dividends of approximately 14.70 would have been received, reducing the overall loss of the Dow to about 8.7%.

It is my objective and my hope (but not my prediction!) that we achieve over a long period of time, an average yearly advantage of ten percentage points relative to the Dow. During the first half we did considerably better than expected with an overall gain of approximately 8.2%. Such results should be regarded as decidedly abnormal. I have previously complimented partners on the good-natured tolerance they display in shrugging off such unexpected positive variances. The nature of our business is such that over the years, we will not disappoint the many of you who must also desire a test of your capacity for tolerance of negative variances.

The following summarizes the year-by-year performance of the Dow, the performance of the Partnership before allocation to the general partner, and the results for limited partners:

Year	**Overall Results From Dow (1)**	**Partnership Results (2)**	**Limited Partners' Results (3)**
1957	-8.4%	10.4%	9.3%
1958	38.5%	40.9%	32.2%
1959	20.0%	25.9%	20.9%
1960	-6.2%	22.8%	18.6%
1961	22.4%	45.9%	35.9%
1962	-7.6%	13.9%	11.9%
1963	20.6%	38.7%	30.5%
1964	18.7%	27.8%	22.3%
1965	14.2%	47.2%	36.9%
First half of 1966	-8.7%	8.2%	7.7%
Cumulative Results	**141.1%**	**1028.7%**	**641.5%**
Annual Compounded Rate	**9.7%**	**29.0%**	**23.5%**

1. Based on yearly changes in the value of the Dow plus dividends that would have been received through ownership of the Dow during that year. The table includes all complete years of partnership activity.

2. For 1957-61 consists of combined results of all predecessor limited partnerships operating throughout the entire year after all expenses but before distributions to partners or allocations to the general partner.

3. For 1957-61 computed on the basis of the preceding column of partnership results allowing for allocation to the general partner based upon the present partnership agreement, but before monthly withdrawals by limited partners.

Even Samson gets clipped occasionally. If you had invested $100.000 on January 1 equally among -

a. the world's largest auto company (General Motors);
b. the world's largest oil company (Standard of New Jersey);
c. the world's largest retailing company (Sears Roebuck);
d. the world's largest chemical company (Dupont);
e. the world's largest steel company (U.S. Steel);
f. the world's largest stockholder-owned insurance company (Aetna);
g. the world's largest public utility (American Telephone & Telegraph);
h. the world's largest bank (Bank of America);

your total portfolio (including dividends received) would have been worth $83,370 on June 30 for a loss of 16.6%. The total market value on January 1 of these eight giants was well over $100 billion. Everyone of them was selling lower on June 30.

Investment Companies

On the next page we bring up to date our regular comparison with the results of the two largest open-end investment companies (mutual funds) that follow a policy of being, typically, 95-100% invested in common stocks, and the two largest diversified closed-end investment companies.

YEARLY RESULTS

Year	**Mass. Inv. Trust (1)**	**Investors Stock (1)**	**Lehman (2)**	**Tri-Cont (2)**	**Dow**	**Limited Partners**
1957	-11.4%	-12.4%	-11.4%	-2.4%	-8.4%	9.3%
1958	42.7%	47.5%	40.8%	33.2%	38.5%	32.2%
1959	9.0%	10.3%	8.1%	8.4%	20.0%	20.9%
1960	-1.0%	-0.6%	2.5%	2.8%	-6.2%	18.6%
1961	25.6%	24.9%	23.6%	22.5%	22.4%	35.9%
1962	-9.8%	-13.4%	-14.4%	-10.0%	-7.6%	11.9%
1963	20.0%	16.5%	23.7%	18.3%	20.6%	30.5%
1964	15.9%	14.3%	13.6%	12.6%	18.7%	22.3%
1965	10.2%	9.8%	19.0%	10.7%	14.2%	36.9%
First half 1966	-7.9%	-7.9%	-1.0%	-5.2%	-8.7%	7.7%
Cumulative Results	**118.1%**	**106.3%**	**142.8%**	**126.9%**	**141.1%**	**641.5%**
Annual Compounded Rate	**8.6%**	**7.9%**	**9.8%**	**9.0%**	**9.7%**	**23.5%**

(1) Computed from changes in asset value plus any distributions to holders of record during year.
(2) From 1966 Moody's Bank & Finance Manual for 1957-1965. Estimated for first half of 1966.

Proponents of institutional investing frequently cite its conservative nature. If "conservative" is interpreted to mean "productive of results varying only slightly from average experience" I believe the characterization is proper. Such results are almost bound to flow from wide diversification among high grade securities. Since, over a long period, "average experience" is likely to be good experience, there is nothing wrong with the typical investor utilizing this form of investment medium.

However, I believe that conservatism is more properly interpreted to mean "subject to substantially less temporary or permanent shrinkage in value than total experience". This simply has not been achieved, as the record of the four largest funds (presently managing over $5 billion) illustrates. Specifically, the Dow declined in 1957, 1960, 1962 and the first half of 1966. Cumulating the shrinkage in the Dow during the three full year periods produces a decline of 20.6%. Following a similar technique for the four largest funds produces declines of 9.7%, 20.9%, 22.3% and 24.6%. Including the interim performance for the first half of 1966 results in a decline in the Dow of 27.5% and for the funds declines of 14.4%, 23.1%, 27.1% and 30.6%. Such funds (and I believe their results are quite typical of institutional experience in common stocks) seem to meet the first definition of conservatism but not the second one.

Most investors would climb a rung intellectually if they clearly delineated between the above two interpretations of conservatism. The first might be better labeled "conventionalism" - what it really says is that “when others are making money in the general run of securities, so will we and to about the same degree; when they are losing money, we'll do it at about the same rate." This is not to be equated with "when others are making it, we'll make as much and when they are losing it, we will lose less.” Very few investment programs accomplish the latter - we certainly don't promise it but we do intend to keep trying. (I have always felt our objectives should be somewhat loftier than those Herman Hickman articulated during the desperate years when Yale was losing eight games a season. Said Herman, "I see my job as one of keeping the alumni sullen but not mutinous.”)

<u>Hochschild, Kohn & Co.</u>

During the first half we, and two 10% partners, purchased all of the stock of Hochschild, Kohn & Co., a privately owned Baltimore department store. This is the first time in the history of the Partnership that an entire business has been purchased by negotiation, although we have, from time to time, negotiated purchase of specific important blocks of marketable securities. However, no new principles are involved. The quantitative and qualitative aspects of the business are evaluated and weighed against price, both on an absolute basis and relative to other investment opportunities. HK (learn to call it that - I didn't find out how to pronounce it until the deal was concluded) stacks up fine in all respects.

We have topnotch people (both from a personal and business standpoint) handling the operation. Despite the edge that my extensive 75 cents an hour experience at the Penney's store in Omaha some years back gives us (I became an authority on the Minimum Wage Act), they will continue to run the business as in the past. Even if the price had been cheaper but the management had been run-of-the-mill, we would not have bought the business.

It is impossible to avoid some public notice when a business with several thousand employees is acquired. However, it is important that you do not infer the degree of financial importance to BPL from its news value to the public. We have something over $50 million invested, primarily in marketable securities, of which only about 10% is represented by our net investment in HK. We have an investment of over three times this much in a marketable security where our ownership will never come to public attention. This is not to say an HK is not important - a 10% holding definitely is. However, it is not as significant relative to our total operation as it would be easy to think. I still prefer the iceberg approach toward investment disclosure.

It is my intention to value HK at yearend at cost plus our share of retained earnings since purchase. This policy will be followed in future years unless there is a demonstrable change in our position relative to other department stores or in other objective standards of value. Naturally we wouldn't have purchased HK unless we felt the price was quite attractive. Therefore, a valuation policy based upon cost may somewhat undervalue our holdings. Nevertheless, it seems the most objective figure to apply. All of our investments usually appear undervalued to me - otherwise we wouldn't own them.

<u>Market Forecasting</u>

Ground Rule No.6 (from our November packet) says: “I am not in the business of predicting general stock market or business fluctuations. If you think I can do this, or think it is essential to an investment program, you should not be in the partnership.”

Of course, this rule can be attacked as fuzzy, complex, ambiguous, vague, etc. Nevertheless, I think the point is well understood by the great majority of our partners. We don't buy and sell stocks based upon what other people think the stock market is going to do (I never have an opinion) but rather upon what we think the company is going to do. The course of the stock market will determine, to a great degree, <u>when</u> we will be right, but the accuracy of our analysis of the company will largely determine <u>whether</u> we will be right. In other words, we tend to concentrate on what should happen, not when it should happen.

In our department store business I can say with considerable assurance that December will be better than July. (Notice how sophisticated I have already become about retailing.) What really counts is whether December is better than last December by a margin greater than our competitors' and what we are doing to set the stage for future Decembers. However, in our partnership business I not only can't say whether December will be better than July, but I can't even say that December won't produce a very large loss. It sometimes does. Our investments are simply not aware that it takes 365-1/4 days for the earth to make it around the sun. Even worse, they are not aware that your celestial orientation (and that of the IRS) requires that I report to you upon the conclusion of each orbit (the earth's - not ours). Therefore, we have to use a standard other than the calendar to measure our progress. This yardstick is obviously the general experience in securities as measured by the Dow. We have a strong feeling that this competitor will do quite decently over a period of years (Christmas will come even if it's in July) and if we keep beating our competitor we will have to do something better than "quite decently". It's something like a retailer measuring his sales gains and profit margins against Sears' - beat them every year and somehow you'll see daylight.

I resurrect this "market-guessing" section only because after the Dow declined from 995 at the peak in February to about 865 in May, I received a few calls from partners suggesting that they thought stocks were going a lot lower. This always raises two questions in my mind: (1) if they knew in February that the Dow was going to 865 in May, why didn't they let me in on it then; and, (2) if they didn't know what was going to happen during the ensuing three months back in February, how do they know in May? There is also a voice or two after any hundred point or so decline suggesting we sell and wait until the future is clearer. Let me again suggest two points: (1) the future has never been clear to me (give us a call when the next few months are obvious to you – or, for that matter the next few hours); and, (2) no one ever seems to call after the market has gone up one hundred points to focus my attention on how unclear everything is, even though the view back in February doesn't look so clear in retrospect.

If we start deciding, based on guesses or emotions, whether we will or won't participate in a business where we should have some long run edge, we're in trouble. We will not sell our interests in businesses (stocks) when they are attractively priced just because some astrologer thinks the quotations may go lower even though such forecasts are obviously going to be right some of the time. Similarly, we will not buy fully priced securities because "experts" think prices are going higher. Who would think of buying or selling a private business because of someone's guess on the stock market? The availability of a question for your business interest (stock) should always be an asset to be utilized if desired. If it gets silly enough in either direction, you take advantage of it. Its availability should never be turned into a liability whereby its periodic aberrations in turn formulate your judgments. A marvelous articulation of this idea is contained in chapter two (The Investor and Stock Market Fluctuations) of Benjamin Graham's <u>"The Intelligent Investor"</u>. In my opinion, this chapter has more investment importance than anything else that has been written.

We will have a letter out about November 1 with the Commitment Letter for 1967 and an estimate of the 1966 tax situation.

Cordially,

Warren Buffett

WEB eh

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January 25, 1967

The First Decade

The Partnership had its tenth anniversary during 1966. The celebration was appropriate -an all-time record (both past and future) was established for our performance margin relative to the Dow. Our advantage was 36 points which resulted from a plus 20.4% for the Partnership and a minus 15.6% for the Dow.

This pleasant but non-repeatable experience was partially due to a lackluster performance by the Dow. Virtually all investment managers outperformed it during the year. The Dow is weighted by the dollar price of the thirty stocks involved. Several of the highest priced components, which thereby carry disproportionate weight (Dupont, General Motors), were particularly poor performers in 1966. This, coupled with the general aversion to conventional blue chips, caused the Dow to suffer relative to general investment experience, particularly during the last quarter.

The following summarizes the year-by-year performance of the Dow, the performance of the Partnership before allocation (one quarter of the excess over 6%) to the general partner, and the results for limited partners:

Year	**Overall Results From Dow (1)**	**Partnership Results (2)**	**Limited Partners' Results (3)**
1957	-8.4%	10.4%	9.3%
1958	38.5%	40.9%	32.2%
1959	20.0%	25.9%	20.9%
1960	-6.2%	22.8%	18.6%
1961	22.4%	45.9%	35.9%
1962	-7.6%	13.9%	11.9%
1963	20.6%	38.7%	30.5%
1964	18.7%	27.8%	22.3%
1965	14.2%	47.2%	36.9%
1966	-15.6%	20.4%	16.8%
Cumulative Results	**141.1%**	**1028.7%**	**641.5%**
Annual Compounded Rate	**9.7%**	**29.0%**	**23.5%**

(1) Based on yearly changes in the value of the Dow plus dividends that would have been received through ownership of the Dow during that year. The table includes all complete years of partnership activity.

(2) For 1957-61 consists of combined results of all predecessor limited partnerships operating throughout the entire year after all expenses, but before distributions to partners or allocations to the general partner.

(3) For 1957-61 computed on the basis of the preceding column of partnership results allowing for allocation to the general partner based upon the present partnership agreement. but before monthly withdrawals by limited partners.

On a cumulative or compounded basis, the results are:

Year	Overall Results From Dow	Partnership Results	Limited Partners' Results
1957	-8.4%	10.4%	9.3%
1957 – 58	26.9%	55.6%	44.5%
1957 – 59	52.3%	95.9%	74.7%
1957 – 60	42.9%	140.6%	107.2%
1957 – 61	74.9%	251.0%	181.6%
1957 – 62	61.6%	299.8%	215.1%
1957 – 63	95.1%	454.5%	311.2%
1957 – 64	131.3%	608.7%	402.9%
1957 – 65	164.1%	943.2%	588.5%
1957 – 66	122.9%	1156.0%	704.2%
Annual Compounded Rate	**11.4%**	**29.8%**	**23.9%**

<u>Investment Companies</u>

On the following page is the usual tabulation showing the results of the two largest open-end investment companies (mutual funds) that follow a policy of being, typically, 95-100% invested in common stocks, and the two largest diversified closed-end investment companies.

Year	Mass. Inv. Trust (1)	Investors Stock (1)	Lehman (2)	Tri-Cont (2)	Dow	Limited Partners
1957	-11.4%	-12.4%	-11.4%	-2.4%	-8.4%	9.3%
1958	42.7%	47.5%	40.8%	33.2%	38.5%	32.2%
1959	9.0%	10.3%	8.1%	8.4%	20.0%	20.9%
1960	-1.0%	-0.6%	2.5%	2.8%	-6.2%	18.6%
1961	25.6%	24.9%	23.6%	22.5%	22.4%	35.9%
1962	-9.8%	-13.4%	-14.4%	-10.0%	-7.6%	11.9%
1963	20.0%	16.5%	23.7%	18.3%	20.6%	30.5%
1964	15.9%	14.3%	13.6%	12.6%	18.7%	22.3%
1965	10.2%	9.8%	19.0%	10.7%	14.2%	36.9%
1966	-7.7%	-10.0%	-2.6%	-6.9%	-15.6%	16.8%
Cumulative Results	**118.1%**	**106.3%**	**142.8%**	**126.9%**	**141.1%**	**641.5%**
Annual Compounded Rate	**8.6%**	**7.9%**	**9.8%**	**9.0%**	**9.7%**	**23.5%**

(1) Computed from changes in asset value plus any distributions to holders of record during year.
(2) From 1966 Moody's Bank & Finance Manual for 1957-1965. Estimated for 1966.

These investment company performance figures have been regularly reported here to show that the now is no patsy as an investment standard. It should again be emphasized that the companies were not selected on the basis of comparability to Buffett Partnership, Ltd. There are important differences including: (1) investment companies operate under both internally and externally imposed restrictions on their investment actions that are not applicable to us; (2) investment companies diversify far more than we do and, in all probability, thereby have less chance for a really bad performance relative to the now in a single year; and (3) their managers have considerably less incentive for abnormal performance and greater incentive for conventionality.

However, the records above do reveal what well-regarded, highly paid, full-time professional investment managers have been able to accomplish while working with common stocks. These managers have been favorites of American investors (more than 600,000) making free choices among many alternatives in the investment management field. It is probable that their results are typical of the overwhelming majority of professional investment managers.

It is not true, however, that these are the best records achieved in the investment field. A few mutual funds and some private investment operations have compiled records vastly superior to the Dow and, in some cases, substantially superior to Buffett Partnership, Ltd. Their investment techniques are usually very dissimilar to ours and not within my capabilities. However, they are generally managed by very bright, motivated people and it is only fair that I mention the existence of such superior results in this general discussion of the record of professional investment management.

Trends in Our Business

A keen mind working diligently at interpreting the figures on page one could come to a lot of wrong conclusions.

The results of the first ten years have absolutely no chance of being duplicated or even remotely approximated during the next decade. They may well be achieved by some hungry twenty-five year old working with $105,100 initial partnership capital and operating during a ten year business and market environment which is frequently conducive to successful implementation of his investment philosophy.

They will not be achieved by a better fed thirty-six year old working with our $54,065,345 current partnership capital who presently finds perhaps one-fifth to one-tenth as many really good ideas as previously to implement his investment philosophy.

Buffett Associates. Ltd. (predecessor to Buffett Partnership. Ltd.) was founded on the west banks of the Missouri. May 5. 1956 by a hardy little band consisting of four family members, three close friends and $105,100. (I tried to find some brilliant flash of insight regarding our future or present conditions from my first page and a half annual letter of January, 1957 to insert as a quote here. However, someone evidently doctored my file copy so as to remove the perceptive remarks I must have made.)

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 experienced a flow of “workout” opportunities where the percentages were very much to our liking. The problem was always which, not what. Accordingly, we were able to own fifteen to twenty-five issues and be enthusiastic about the probabilities inherent in all holdings.

In the last few years this situation has changed dramatically. We now find very few securities that are understandable to me, available in decent size, and which offer the expectation of investment performance meeting our yardstick of ten percentage points per annum superior to the Dow. In the last three years we have come up with only two or three new ideas a year that have had such an expectancy of superior performance. Fortunately, in some cases, we have made the most of them. However, in earlier years, a lesser effort produced literally dozens of comparable opportunities. It is difficult to be objective about the causes for such diminution of one's own productivity. Three factors that seem apparent are: (1) a somewhat changed market environment; (2) our increased size; and (3) substantially more competition.

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 true because there is only so much one can digest (million dollar ideas are of no great benefit to thousand dollar bank accounts - this was impressed on me in my early days) and because a limited number of ideas causes one to utilize those available more intensively. The latter factor has definitely been operative with us in recent years. However, a trickle has considerably more chance of drying up completely than a flow.

These conditions will not cause me to attempt investment decisions outside my sphere of understanding (I don't go for the "If you can't lick 'em, join 'em" philosophy - my own leaning is toward "If you can't join 'em, lick 'em"). We will not go into businesses where technology which is away over my head is crucial to the investment decision. I know about as much about semi-conductors or integrated circuits as I do of the mating habits of the chrzaszcz. (That's a Polish May bug, students - if you have trouble pronouncing it, rhyme it with thrzaszcz.)

Furthermore, we will not follow the frequently prevalent approach of investing in securities where an attempt to anticipate market action overrides business valuations. Such so-called "fashion" investing has frequently produced very substantial and quick profits in recent years (and currently as I write this in January). It represents an investment technique whose soundness I can neither affirm nor deny. It does not completely satisfy my intellect (or perhaps my prejudices), and most definitely does not fit my temperament. I will not invest my own money based upon such an approach hence, I will most certainly not do so with your money.

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.

What I do promise you, as partners, is that I will work hard to maintain the trickle of ideas and try to get the most out of it that is possible – but if it should dry up completely, you will be informed honestly and promptly so that we may all take alternative action.

Analysis of 1966 Results

All four main categories of our investment operation worked out well in 1966. Specifically, we had a total overall gain of $8,906,701 derived as follows:

Category	Average Investment	Overall Gain
Controls	$17,259,342	$1,566,302
Generals – Private Owner	$1,359,340	$1,004,362
Generals – Relatively Undervalued	$21,847,045	$5,124254
Workouts	$7,666314	$1,714,181
Miscellaneous, including US Treasury Bills	$1,332,609	$(18,422)
Total Income		$9,390,677
Less: General Expense		$483,976
Overall Gain		$8,906,701

A few caveats are necessary before we get on with the main discussion:

1. An explanation of the various categories listed above was made in the January 18, 1965 letter. If your memory needs refreshing and your favorite newsstand does not have the pocketbook edition. we'll be glad to give you a copy.

2. The classifications are not iron-clad. Nothing is changed retroactively but the initial decision as to category is sometimes arbitrary.

3. Percentage returns calculated on the average investment base by category would be understated relative to partnership percentage returns which are calculated on a beginning investment base. In the above figures, a security purchased by us at 100 on January 1 which appreciated at an even rate to 150 on December 31 would have an average investment of 125 producing a 40% result contrasted to a 50% result by the customary approach. In other words, the above figures use a monthly average of market values in calculating the average investment.

4. All results are based on a 100% ownership, non-leverage, basis. Interest and other general expenses are deducted from total performance and not segregated by category. Expenses directly related to specific investment operations, such as dividends paid on short stock, are deducted by category. When securities are borrowed directly and sold short, the net investment (longs minus shorts) is shown for the applicable average investment category.

5. The above table has only limited use. The results applicable to each category are dominated by one or two investments. They do not represent a collection of great quantities of stable data (mortality rates of all American males or something of the sort) from which conclusions can be drawn and projections made. Instead, they represent infrequent, non-homogeneous phenomena leading to very tentative suggestions regarding various courses of action and are so used by us.

6. Finally, these calculations are not made with the same loving care we apply to counting the money and are subject to possible clerical or mathematical error since they are not entirely self-checking.

Controls

There were three main sources of gain during 1966 in respect to controlled companies. These arose through: (1) retained business earnings applicable to our holdings in 1966; (2) open market purchases of additional stock below our controlling interest valuation and; (3) unrealized appreciation in marketable securities held by the controlled companies. The total of all positive items came to $2,600,838 in 1966.

However, due to factors mentioned in my November 1, 1966 letter, specific industry conditions, and other relevant valuation items, this gain was reduced by $1,034,780 in arriving at our fair valuation applicable to controlling interests as of December 31, 1966. Thus the overall gain in the control category was reduced to $1,566,058 for the year.

We were undoubtedly fortunate that we had a relatively high percentage of net assets invested in businesses and not stocks during 1966. The same money in general market holdings would probably have produced a loss, perhaps substantial, during the year. This was not planned and if the stock market had advanced substantially during the year, this category would have been an important drag on overall performance. The same situation will prevail during 1967.

Generals -Private Owner

Our performance here falls in the "twenty-one dollars a day, once a month" category. In the middle of 1965 we started purchasing a very attractive widely held security which was selling far below its value to a private owner. Our hope was that over a two or three year period we could get $10 million or more invested at the favorable prices prevailing. The various businesses that the company operated were understandable and we could check out competitive strengths and weaknesses thoroughly with competitors, distributors, customers, suppliers, ex-employees, etc. Market conditions peculiar to the stock gave us hope that, with patience, we could buy substantial quantities of the stock without disturbing the price.

At yearend 1965 we had invested $1,956,980 and the market value of our holding was $2,358,412 so that $401,432 was contributed to performance luring 1965. We would have preferred, of course, to have seen the market below cost since our interest was in additional buying, not in selling. This would have dampened Buffett Partnerships Ltd.'s 1965 performance and perhaps reduced the euphoria experienced by limited partners (psychically, the net result to all partners would have been a standoff since the general partner would have been floating) but would have enhanced long term performance. The fact that the stock had risen somewhat above our cost had already slowed down our buying program and thereby reduced ultimate profit.

An even more dramatic example of the conflict between short term performance and the maximization of long term results occurred in 1966. Another party, previously completely unknown to me, issued a tender offer which foreclosed opportunities for future advantageous buying. I made the decision that the wisest course (it may not have been) for us to follow was to dispose of our holdings and we thus realized a total profit of $1,269,181 in February, of which $867,749 was applicable to 1966.

While any gains looked particularly good in the market environment that intimately developed in 1966, you can be sure I don't delight in going round making molehills out of mountains. The molehill, of course, was reflected in 1966 results. However, we would have been much better off from a long range standpoint if 1966 results had been five percentage points worse and we were continuing to buy substantial quantities of the stock at the depressed prices that might have been expected to prevail in this year's market environment.

Good ideas were a dime a dozen, such a premature ending would not be unpleasant. There is something to be said, of course, for a business operation where some of the failures produce moderate profits. However, you can see how hard it is to develop replacement ideas by examining our average investment in the Private Owner category - we came up with nothing during the remainder of the year despite lower stock prices, which should have been conducive to finding such opportunities.

<u>Generals - Relatively Undervalued</u>

Our relative performance in this category was the best we have ever had - due to one holding which was our largest investment at yearend 1965 and also yearend 1966. This investment has substantially out-performed the general market for us during each year (1964, 1965, 1966) that we have held it. While any single year's performance can be quite erratic, we think the probabilities are highly favorable for superior future performance over a three or four year period. The attractiveness and relative certainty of this particular security are what caused me to introduce Ground Rule 7 in November, 1965 to allow individual holdings of up to 40% of our net assets. We spend considerable effort continuously evaluating every facet of the company and constantly testing our hypothesis that this security is superior to alternative investment choices. Such constant evaluation and comparison at shifting prices is absolutely essential to our investment operation.

It would be much more pleasant (and indicate a more favorable future) to report that our results in the Generals - Relatively Undervalued category represented fifteen securities in ten industries, practically all of which outperformed the market. We simply don't have that many good ideas. As mentioned above, new ideas are continually measured against present ideas and we will not make shifts if the effect is to downgrade expectable performance. This policy has resulted in limited activity in recent years when we have felt so strongly about the relative merits of our largest holding. Such a condition has meant that realized gains have been a much smaller portion of total performance than in earlier years when the flow of good ideas was more substantial.

The sort of concentration we have in this category is bound to produce wide swings in short term performance – some, most certainly, unpleasant. There have already been some of these applicable to shorter time spans than I use in reporting to partners. This is one reason I think frequent reporting to be foolish and potentially misleading in a long term oriented business such as ours.

Personally, within the limits expressed in last year's letter on diversification, I am willing to trade the pains (forget about the pleasures) of substantial short term variance in exchange for maximization of long term performance. However, I am not willing to incur risk of substantial permanent capital loss in seeking to better long term performance. To be perfectly clear - under our policy of concentration of holdings, partners should be completely prepared for periods of substantial underperformance (far more likely in sharply rising markets) to offset the occasional over performance such as we have experienced in 1965 and 1966, and as a price we pay for hoped-for good long term performance.

All this talk about the long pull has caused one partner to observe that “even five minutes is a long time if one's head is being held under water." This is the reason, of course, that we use borrowed money very sparingly in our operation. Average bank borrowings during 1966 were well under 10% of average net worth.

One final word about the Generals - Relatively Undervalued category. In this section we also had an experience which helped results in 1966 but hurt our long term prospects. We had just one really important new idea in this category in 1966. Our purchasing started in late spring but had only come to about $1.6 million (it could be bought steadily but at only a moderate pace) when outside conditions drove the stock price up to a point where it was not relatively attractive. Though our overall gain was $728,141 on an average holding period of six and a half months in 1966, it would have been much more desirable had the stock done nothing for a long period of time while we accumulated a really substantial position.

<u>Workouts</u>

In last year's letter I forecast reduced importance for workouts. While they were not of the importance of some past years. I was pleasantly surprised by our experience in 1966 during which we kept an average of $7,666,314 employed in this category. Furthermore, we tend to ascribe borrowings to the workout section so that our net equity capital employed was really something under this figure and our return was somewhat better than the 22.4% indicated on page six. Here, too, we ran into substantial variation. At June 30, our overall profit on this category was $16,112 on an average investment of $7,870,151 so that we really had a case of an extraordinarily good second half offsetting a poor first half.

In past years, sometimes as much as 30-40% of our net worth has been invested in workouts, but it is highly unlikely that this condition will prevail in the future. Nevertheless, they may continue to produce some decent returns on the moderate amount of capital employed.

<u>Miscellaneous</u>

Operationally, we continue to function well above rated capacity with Bill, John, Elizabeth and Donna all contributing excellent performances. At Buffett Partnership. Ltd. we have never had to divert investment effort to offset organizational shortcomings and this has been an important ingredient in the performance over the years.

Peat, Marwick, Mitchell & Co., aided for the second year by their computer, turned in the usual speedy, efficient and comprehensive job.

We all continue to maintain more than an academic interest in the Partnership. The employees and I, our spouses and children, have a total of over $10 million invested at January 1, 1967. In the case of my family, our Buffett Partnership, Ltd. investment represents well over 90% of our net worth.

Within the coming two weeks you will receive:

1. A tax letter giving you all BPL information needed for your 1966 federal income tax return. This letter is the only item that counts for tax purposes.

2. An audit from Peat, Marwick, Mitchell & Co. for 1966, setting forth the operations and financial position of BPL, as well as your own capital account.

3. A letter signed by me setting forth the status of your BPL interest on January 1, 1967. This is identical with the figures developed in the audit.

Let me know if anything in this letter or that occurs during the year needs clarifying. My next letter will be about July 15 summarizing the first half of this year.

Cordially,

Warren E. Buffett

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July 12, 1967

First Half Performance

Again, this is being ,written in late June prior to the family's trip to California. To maintain the usual chronological symmetry (I try to sublimate my aesthetic urges when it comes to creating symmetry in the profit and loss statement), I will leave a few blanks and trust that the conclusions look appropriate when the figures are entered.

We began 1967 on a traumatic note with January turning out to be one of the worst months we have experienced with a plus 3.3% for BPL versus a plus 8.5% for the Dow. Despite this sour start, we finished the half about plus 21% for an edge of 9.6 percentage points over the Dow. Again, as throughout 1966, the Dow was a relatively easy competitor (it won't be every year, prevailing thinking to the contrary notwithstanding) and a large majority of investment managers outdid this yardstick. The following table summarizes performance to date on the usual basis:

Year	**Overall Results From Dow (1)**	**Partnership Results (2)**	**Limited Partners' Results (3)**
1957	-8.4%	10.4%	9.3%
1958	38.5%	40.9%	32.2%
1959	20.0%	25.9%	20.9%
1960	-6.2%	22.8%	18.6%
1961	22.4%	45.9%	35.9%
1962	-7.6%	13.9%	11.9%
1963	20.6%	38.7%	30.5%
1964	18.7%	27.8%	22.3%
1965	14.2%	47.2%	36.9%
1966	-15.6%	20.4%	16.8%
First half 1967	11.4%	21.0%	17.3%
Cumulative Results	**148.3%**	**1419.8%**	**843.3%**
Annual Compounded Rate	**9.1%**	**29.6%**	**23.8%**

(1) Based on yearly changes in the value of the Dow plus dividends that would have been received through ownership of the Dow during that year. The table includes all complete years of partnership activity.

(2) For 1957-61 consists of combined results of all predecessor limited partnerships operating throughout the entire year after all expenses but before distributions to partners or allocations to the general partner.

(3) For 1957-61 computed on the basis of the preceding column of partnership results allowing for allocation to the general partner based upon the present partnership agreement, but before monthly withdrawals by limited partners.

BPL's performance during the first hall reflects no change in valuation of our controlled companies and was thus achieved solely by the 63.3% of our net assets invested in marketable securities at the beginning of the year.

Any revaluation of Diversified Retailing Company (DRC) and Berkshire Hathaway Inc. (B-H) will be made in December prior to the time the commitment letters become final and will be based upon all relevant criteria (including current operating. market and credit conditions) at that time.

Both DRC and B-H made important acquisitions during the first half. The overall progress of DRC (80% owned) and both of its subsidiaries (Hochschild Kohn and Associated Cotton Shops) is highly satisfactory. However, B-H is experiencing and faces real difficulties in the textile business, while I don't presently foresee any loss in underlying values. I similarly see no prospect of a good return on the assets employed in the textile business. Therefore, this segment of our portfolio will be a substantial drag on our relative performance (as it has been during the first half) if the Dow continues to advance. Such relative performance with controlled companies is expected in a strongly advancing market, but is accentuated when the business is making no progress. As a friend of mine says. “Experience is what you find when you're looking for something else.”

Investment Companies

The usual comparison follows showing the results of the two largest open-end and two largest closed-end investment companies which pursue a policy of 95-100% investment in common stocks.

Year	Mass. Inv. Trust (1)	Investors Stock (1)	Lehman (2)	Tri-Cont (2)	Dow	Limited Partners
1957	-11.4%	-12.4%	-11.4%	-2.4%	-8.4%	9.3%
1958	42.7%	47.5%	40.8%	33.2%	38.5%	32.2%
1959	9.0%	10.3%	8.1%	8.4%	20.0%	20.9%
1960	-1.0%	-0.6%	2.5%	2.8%	-6.2%	18.6%
1961	25.6%	24.9%	23.6%	22.5%	22.4%	35.9%
1962	-9.8%	-13.4%	-14.4%	-10.0%	-7.6%	11.9%
1963	20.0%	16.5%	23.7%	18.3%	20.6%	30.5%
1964	15.9%	14.3%	13.6%	12.6%	18.7%	22.3%
1965	10.2%	9.8%	19.0%	10.7%	14.2%	36.9%
1966	-7.7%	-10.0%	-2.6%	-6.9%	-15.6%	16.8%
First half 1967	11.3%	12.3%	19.3%	14.4%	11.4%	17.3%
Cumulative Results	**143.3%**	**126.4%**	**185.4%**	**156.8%**	**148.3%**	**843.3%**
Annual Compounded Rate	**8.9%**	**8.1%**	**10.5%**	**9.4%**	**9.1%**	**23.8%**

(1) Computed from changes in asset value plus any distributions to holders of record during year.
(2) From 1967 Moody's Bank & Finance Manual for 1957-1966. Estimated for first half of 1967.

The tide continues to be far more important than the swimmers.

Taxes

We entered 1967 with unrealized gains of $16,361,974. Through June 30 we have realized net capital gains of $7,084,104 so it appears likely that we will realize in 1967 a fairly substantial portion of the unrealized gain attributable to your interest at the beginning of the year. This amount was reported to you as Item 3 of our February 2, 1967 letter. A copy of that letter, along with a tax letter, will be mailed to you in November giving a rough idea of the tax situation at that time.

As I regularly suggest, the safe course to follow on interim estimates is to pay the same estimated tax for 1967 as your actual tax was for 1966. There can be no penalties if you follow this procedure.

Whatever our final figure, it looks now as if it will be very largely long term capital gain with only minor amounts, if any, of short term gain and ordinary income. (I consider the whole Income-Principal Myth fair game for one of my soft-spoken gently worded critiques. As I told Susie in the early days of our marriage, “Don't worry about the income; just the outcome.”)

Miscellaneous

During the first half, Stan Perimeter resigned from the Dissolution Committee because of his present full-time involvement in investment management. Fred Stanback, Jr., a long time partner and experienced investor, was elected by the remaining members to fill the vacancy.

As in past years, we will have a report out about November 11 along with the Commitment Letter, and the rough estimate of the 1967 tax situation, etc.

However, there will be a special letter (to focus your attention upon it) in October. The subject matter will not relate to change in the Partnership Agreement, but will involve some evolutionary changes in several "Ground Rules" which I want you to have ample time to contemplate before making your plans for 1968. Whereas the Partnership Agreement represents the legal understanding among us, the "Ground Rules" represent the personal understanding and in some ways is the more important document. I consider it essential that any changes be clearly set forth and explained prior to their effect on partnership activity or performance – hence, the October letter.

Cordially,

Warren E. Buffett

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October 9, 1967

To My Partners:

Over the past eleven years, I have consistently set forth as the BPL investment goal an average advantage in our performance of ten percentage points per annum in comparison with the Dow Jones Industrial Average. Under the environment that existed during that period. I have considered such an objective difficult but obtainable.

The following conditions now make a change in yardsticks appropriate:

1. The market environment has changed progressively over the past decade, resulting in a sharp diminution in the number of obvious quantitatively based investment bargains available;

2. Mushrooming interest in investment performance (which has its ironical aspects since I was among a lonely few preaching the importance of this some years ago) has created a hyper-reactive pattern of market behavior against which my analytical techniques have limited value;

3. The enlargement of our capital base to about $65 million when applied against a diminishing trickle of good investment ideas has continued to present the problems mentioned in the January, 1967 letter; and

4. My own personal interests dictate a less compulsive approach to superior investment results than when I was younger and leaner.

Let's look at each of these factors in more detail.

The evaluation of securities and businesses for investment purposes has always involved a mixture of qualitative and quantitative factors. At the one extreme, the analyst exclusively oriented to qualitative factors would say. "Buy the right company (with the right prospects, inherent industry conditions, management, etc.) and the price will take care of itself." On the other hand, the quantitative spokesman would say, "Buy at the right price and the company (and stock) will take care of itself." As is so often the pleasant result in the securities world, money can be made with either approach. And, of course, any analyst combines the two to some extent - his classification in either school would depend on the relative weight he assigns to the various factors and not to his consideration of one group of factors to the exclusion of the other group.

Interestingly enough, although I consider myself to be primarily in the quantitative school (and as I write this no one has come back from recess - I may be the only one left in the class), the really sensational ideas I have had over the years have been heavily weighted toward the qualitative side where I have had a "high-probability insight". This is what causes the cash register to really sing. However, it is an infrequent occurrence, as insights usually are, and, of course, no insight is required on the quantitative side - the figures should hit you over the head with a baseball bat. So the really big money tends to be made by investors who are right on qualitative decisions but, at least in my opinion, the more sure money tends to be made on the obvious quantitative decisions.

Such statistical bargains have tended to disappear over the years. This may be due to the constant combing and recombing of investments that has occurred during the past twenty years, without an economic convulsion such as that of the '30s to create a negative bias toward equities and spawn hundreds of new bargain securities. It may be due to the new growing social acceptance, and therefore usage (or maybe it's vice versa - I'll let the behaviorists figure it out) of takeover bids which have a natural tendency to focus on bargain issues. It may be due to the exploding ranks of security analysts bringing forth an intensified scrutiny of issues far beyond what existed some years ago. Whatever the cause, the result has been the virtual disappearance of the bargain issue as determined quantitatively - and thereby of our bread and butter. There still may be a few from time to time. There will also be the occasional security where I am really competent to make an important qualitative judgment. This will offer our best chance for large profits. Such instances will. however, be rare. Much of our good performance during the past three years has been due to a single idea of this sort.

The next point of difficulty is the intensified interest in investment performance. For years I have preached the importance of measurement. Consistently I have told partners that unless our performance was better than average, the money should go elsewhere. In recent years this idea has gained momentum throughout the investment (or more importantly, the investing) community. In the last year or two it has started to look a bit like a tidal wave. I think we are witnessing the distortion of a sound idea.

I have always cautioned partners that I considered three years a minimum in determining whether we were "performing". Naturally, as the investment public has taken the bit in its teeth, the time span of expectations has been consistently reduced to the point where investment performance by large aggregates of money is being measured yearly, quarterly, monthly, and perhaps sometimes even more frequently (leading to what is known as "instant research"). The payoff for superior short term performance has become enormous, not only in compensation for results actually achieved, but in the attraction of new money for the next round. Thus a self-generating type of activity has set in which leads to larger and larger amounts of money participating on a shorter and shorter time span. A disturbing corollary is that the vehicle for participation (the particular companies or stocks) becomes progressively less important - at times virtually incidental - as the activity accelerates.

In my opinion what is resulting is speculation on an increasing scale. This is hardly a new phenomenon; however, a dimension has been added by the growing ranks of professional (in many cases formerly quite docile) investors who feel they must “get aboard”. The game is dignified, of course, by appropriate ceremonies, personages and lexicon. To date it has been highly profitable. It may also be that this is going to be the standard nature of the market in the future. Nevertheless, it is an activity at which I am sure I would not do particularly well. As I said on page five of my last annual letter,

> "Furthermore, we will not follow the frequently prevalent approach of investing in securities where an attempt to anticipate market action overrides business valuations. Such so-called 'fashion' investing has frequently produced very substantial and quick profits in recent years (and currently as I write this in January). It represents an investment technique whose soundness I can neither affirm nor deny. It does not completely satisfy my intellect (or perhaps my prejudices), and most definitely does not fit my temperament. I will not invest my own money based upon such an approach – hence, I will most certainly not do so with your money.”

Any form of hyper-activity with large amounts of money in securities markets can create problems for all participants. I make no attempt to guess the action of the stock market and haven't the foggiest notion as to whether the Dow will be at 600, 900 or 1200 a year from now. Even if there are serious consequences resulting from present and future speculative activity, experience suggests estimates of timing are meaningless. However, I do believe certain conditions that now exist are likely to make activity in markets more difficult for us for the intermediate future.

The above may simply be "old-fogeyism" (after all, I am 37). When the game is no longer being played your way, it is only human to say the new approach is all wrong, bound to lead to trouble, etc. I have been scornful of such behavior by others in the past. I have also seen the penalties incurred by those who evaluate conditions as they were - not as they are. Essentially I am out of step with present conditions. On one point, however, I am clear. I will not abandon a previous approach whose logic I understand (although I find it difficult to apply) even though it may mean foregoing large and apparently easy, profits to embrace an approach which I don't fully understand, have not practiced successfully and which, possibly, could lead to substantial permanent loss of capital.

The third point of difficulty involves our much greater base of capital. For years my investment ideas were anywhere from 110% to 1000% of our capital. It was difficult for me to conceive that a different condition could ever exist. I promised to tell partners when it did and in my January, 1967 letter had to make good on that promise. Largely because of the two conditions previously mentioned, our greater capital is now something of a drag on performance. I believe it is the least significant factor of the four mentioned, and that if we were operating with one-tenth of our present capital our performance would be little better. However, increased funds are presently a moderately negative factor.

The final, and most important, consideration concerns personal motivation. When I started the partnership I set the motor that regulated the treadmill at "ten points better than the DOW". I was younger, poorer and probably more competitive. Even without the three previously discussed external factors making for poorer performance. I would still feel that changed personal conditions make it advisable to reduce the speed of the treadmill. I have observed many cases of habit patterns in all activities of life, particularly business, continuing (and becoming accentuated as years pass) long after they ceased making sense. Bertrand Russell has related the story of two Lithuanian girls who lived at his manor subsequent to World War I. Regularly each evening after the house was dark, they would sneak out and steal vegetables from the neighbors for hoarding in their rooms; this despite the fact that food was bountiful at the Russell table. Lord Russell explained to the girls that while such behavior may have made a great deal of sense in Lithuania during the war, it was somewhat out of place in the English countryside. He received assenting nods and continued stealing.

He finally contented himself with the observation that their behavior, strange as it might seem to the neighbors, was really not so different from that of the elder Rockefeller.

Elementary self-analysis tells me that I will not be capable of less than all-out effort to achieve a publicly proclaimed goal to people who have entrusted their capital to me. All-out effort makes progressively less sense. I would like to have an economic goal which allows for considerable non-economic activity. This may mean activity outside the field of investments or it simply may mean pursuing lines within the investment field that do not promise the greatest economic reward. An example of the latter might be the continued investment in a satisfactory (but far from spectacular) controlled business where I liked the people and the nature of the business 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 when the personal value of incremental capital is less) to continue to own them and hopefully improve their performance, usually in a minor way, through some decisions involving financial strategy.

Thus, I am likely to limit myself to things which are reasonably easy, safe, profitable and pleasant. This will not make our operation more conservative than in the past since I believe, undoubtedly with some bias, that we have always operated with considerable conservatism. The long-term downside risk will not be less; the upside potential will merely be less.

Specifically, our longer term goal will be to achieve the lesser of 9% per annum or a five percentage point advantage over the Dow. Thus, if the Dow averages -2% over the next five years, I would hope to average +3% but if the Dow averages +12%, I will hope to achieve an average of only +9%. These may be limited objectives, but I consider it no more likely that we will achieve even these more modest results under present conditions than I formerly did that we would achieve our previous goal of a ten percentage point average annual edge over the Dow. Furthermore, I hope limited objectives will make for more limited effort (I'm quite sure the converse is true).

I will incorporate this new goal into the Ground Rules to be mailed you about November 1, along with the 1968 Commitment Letter. I wanted to get this letter off to you prior to that mailing so you would have ample time to consider your personal situation, and if necessary get in touch with me to clear up some of the enclosed, before making a decision on 1968. As always, I intend to continue to leave virtually all of my capital (excluding Data Documents stock), along with that of my family, in BPL. What I consider satisfactory and achievable may well be different from what you consider so. Partners with attractive alternative investment opportunities may logically decide that their funds can be better employed elsewhere, and you can be sure I will be wholly in sympathy with such a decision.

I have always found behavior most distasteful which publicly announces one set of goals and motivations when actually an entirely different set of factors prevails. Therefore, I have always tried to be l00% candid with you about my goals and personal feelings so you aren't making important decisions pursuant to phony proclamations (I've run into a few of these in our investment experience). Obviously all the conditions enumerated in this letter haven't appeared overnight. I have been thinking about some of the points involved for a long period of time. You can understand, I am sure, that I wanted to pick a time when past goals had been achieved to set forth a reduction in future goals. I would not want to reduce the speed of the treadmill unless I had fulfilled my objectives to this point.

Please let me know if I can be of any help in deciphering any portion of this letter.

Cordially,

Warren E. Buffett

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January 24, 1968

Our Performance in 1967

By most standards, we had a good year in 1967. Our overall performance was plus 35.9% compared to plus 19.0% for the Dow, thus surpassing our previous objective of performance ten points superior to the Dow. Our overall gain was $19,384,250 which, even under accelerating inflation, will buy a lot of Pepsi. And, due to the sale of some longstanding large positions in marketable securities, we had realized taxable income of $27,376,667 which has nothing to do with 1967 performance but should give all of you a feeling of vigorous participation in The Great Society on April 15th.

The minor thrills described above are tempered by any close observation of what really took place in the stock market during 1967. Probably a greater percentage of participants in the securities markets did substantially better than the Dow last year than in virtually any year in history. In 1967, for many, it rained gold and it paid to be out playing the bass tuba. I don't have a final tabulation at this time but my guess is that at least 95% of investment companies following a common stock program achieved better results than the Dow - in many cases by very substantial amounts. It was a year when profits achieved were in inverse proportion to age - and I am in the geriatric ward, philosophically.

The following summarizes the year-by-year performance of the Dow, the Partnership before allocation (one quarter of the excess over 6%) to the general partner, and the results for limited partners:

Year	**Overall Results From Dow (1)**	**Partnership Results (2)**	**Limited Partners' Results (3)**
1957	-8.4%	10.4%	9.3%
1958	38.5%	40.9%	32.2%
1959	20.0%	25.9%	20.9%
1960	-6.2%	22.8%	18.6%
1961	22.4%	45.9%	35.9%
1962	-7.6%	13.9%	11.9%
1963	20.6%	38.7%	30.5%
1964	18.7%	27.8%	22.3%
1965	14.2%	47.2%	36.9%
1966	-15.6%	20.4%	16.8%
1967	19.0%	35.9%	28.4%

(1) Based on yearly changes in the value of the Dow plus dividends that would have been received through ownership of the Dow during that year. The table includes all complete years of partnership activity.

(2) For 1957-61 consists of combined results of all predecessor limited partnerships operating throughout the entire year after all expenses, but before distributions to partners or allocations to the general partner.

(3) For 1957-61 computed on the basis of the preceding column of partnership results allowing for allocation to the general partner based upon the present partnership agreement, but before monthly

withdrawals by limited partners.

On a cumulative or compounded basis, the results are:

Year	Overall Results From Dow	Partnership Results	Limited Partners' Results
1957	-8.4%	10.4%	9.3%
1957 – 58	26.9%	55.6%	44.5%
1957 – 59	52.3%	95.9%	74.7%
1957 – 60	42.9%	140.6%	107.2%
1957 – 61	74.9%	251.0%	181.6%
1957 – 62	61.6%	299.8%	215.1%
1957 – 63	95.1%	454.5%	311.2%
1957 – 64	131.3%	608.7%	402.9%
1957 – 65	164.1%	943.2%	588.5%
1957 – 66	122.9%	1156.0%	704.2%
1957 – 67	165.3%	1606.9%	932.6%
Annual Compounded Rate	**9.3%**	**29.4%**	**23.6%**

<u>Investment Companies</u>

On the following page is the usual tabulation showing the results of what were the two largest mutual funds (they have stood at the top in size since BPL was formed - this year, however, Dreyfus Fund overtook them) that follow a policy of being, typically, 95-100% invested in common stocks, and the two largest diversified closed-end investment companies.

Year	Mass. Inv. Trust (1)	Investors Stock (1)	Lehman (2)	Tri-Cont (2)	Dow	Limited Partners
1957	-11.4%	-12.4%	-11.4%	-2.4%	-8.4%	9.3%
1958	42.7%	47.5%	40.8%	33.2%	38.5%	32.2%
1959	9.0%	10.3%	8.1%	8.4%	20.0%	20.9%
1960	-1.0%	-0.6%	2.5%	2.8%	-6.2%	18.6%
1961	25.6%	24.9%	23.6%	22.5%	22.4%	35.9%
1962	-9.8%	-13.4%	-14.4%	-10.0%	-7.6%	11.9%
1963	20.0%	16.5%	23.7%	18.3%	20.6%	30.5%
1964	15.9%	14.3%	13.6%	12.6%	18.7%	22.3%
1965	10.2%	9.8%	19.0%	10.7%	14.2%	36.9%
1966	-7.7%	-10.0%	-2.6%	-6.9%	-15.6%	16.8%
1967	20.0%	22.8%	28.0%	25.4%	19.0%	28.4%
Cumulative Results	**162.3%**	**147.6%**	**206.2%**	**181.5%**	**165.3%**	**932.6%**
Annual Compounded Rate	**9.2%**	**8.6%**	**10.7%**	**9.9%**	**9.3%**	**23.6%**

(1) Computed from changes in asset value plus any distributions to holders of record during year.
(2) From 1967 Moody's Bank & Finance Manual for 1957-1966. Estimated for 1967.

Last year I said:

> "A few mutual funds and some private investment operations have compiled records vastly superior to the Dow and, in some cases, substantially superior to Buffett Partnership, Ltd. Their investment techniques are usually very dissimilar to ours and not within my capabilities."

In 1967 this condition intensified. Many investment organizations performed substantially better than BPL, with gains ranging to over 100%. Because of these spectacular results, money, talent and energy are converging in a maximum effort for the achievement of large and quick stock market profits. It looks to me like greatly intensified speculation with concomitant risks -but many of the advocates insist otherwise.

My mentor, Ben Graham, used to say. "Speculation is neither illegal, immoral nor fattening (financially)." During the past year, it was possible to become fiscally flabby through a steady diet of speculative bonbons. We continue to eat oatmeal but if indigestion should set in generally, it is unrealistic to expect that we won't have some discomfort.

<u>Analysis of 1967 Results</u>

The overall figures given earlier conceal vast differences in profitability by portfolio category during 1967.

We had our worst performance in history in the "Workout" section. In the 1965 letter, this category was defined as,

> "...securities with a timetable. They arise from corporate activity -- sell-outs, mergers, reorganizations, spin-offs, etc. In this category, we are not talking about rumors or inside information pertaining to such developments, but to publicly announced activities of this sort. We wait until we can read it in the paper. The risk does not pertain primarily to general market behavior (although that is sometimes tied in. to a degree). but instead to something upsetting the applecart so that the expected corporate development does not materialize."

The streets were filled with upset applecarts - our applecarts - during 1967. Thus, on an average investment of $17,246,879, our overall gain was $153,273. For those of you whose slide rule does not go to such insulting depths, this represents a return of .89 of 1%. While I don't have complete figures. I doubt that we have been below 10% in any past year. As in other categories, we tend to concentrate our investments in the workout category in just a few situations per year. This technique gives more variation in yearly results than would be the case if we used an across-the-board approach. I believe our approach will result in as great (or greater) profitability on a long-term basis, but you can't prove it by 1967.

Our investment in controlled companies was a similar drag on relative performance in 1967, but this is to be expected in strong markets. On an average investment of $20,192,776 we had an overall gain of $2,894,571. I am pleased with this sort of performance, even though this category will continue to underperform if the market continues strong during 1968. Through our two controlled companies (Diversified Retailing and Berkshire Hathaway), we acquired two new enterprises in 1967. Associated Cotton Shops and National Indemnity (along with National Fire & Marine, an affiliated company). These acquisitions couldn't be more gratifying. Everything was as advertised or better. The principal selling executives, Ben Rosner and Jack Ringwalt, have continued to do a superb job (the only kind they know), and in every respect have far more than lived up to their end of the bargain.

The satisfying nature of our activity in controlled companies is a minor reason for the moderated investment objectives discussed in the October 9th letter. When I am dealing with people I like, in businesses I find stimulating (what business isn't ?), and achieving worthwhile overall returns on capital employed (say, 10 - 12%), it seems foolish to rush from situation to situation to earn a few more percentage points. It also does not seem sensible to me to trade known pleasant personal relationships with high grade people, at a decent rate of return, for possible irritation, aggravation or worse at potentially higher returns. Hence, we will continue to keep a portion of our capital (but not over 40% because of the possible liquidity requirements arising from the nature of our partnership agreement) invested in controlled operating businesses at an expected rate of return below that inherent in an aggressive stock market operation.

With a combined total of $37,439,655 in workouts and controls producing an overall gain of only $3,047,844, the more alert members of the class will have already concluded we had a whale of a year in the "Generals - Relatively Undervalued" category. On a net average investment of $19,487,996, we had an overall gain of $14,096,593, or 72%. Last year I referred to one investment which substantially outperformed the general market in 1964, 1965 and 1966 and because of its size (the largest proportion we have ever had in anything - we hit our 40% limit) had a very material impact on our overall results and, even more so, this category. This excellent performance continued throughout 1967 and a large portion of total gain was again accounted for by this single security. Our holdings of this security have been very substantially reduced and we have nothing in this group remotely approaching the size or potential which formerly existed in this investment.

The "Generals - Private Owner" section produced good results last year ($1,297,215 on $5,141,710 average investment), and we have some mildly interesting possibilities in this area at present.

<u>Miscellaneous</u>

We begin the new year with net assets of $68,108,088. We had partners with capital of about $1,600,000 withdraw at yearend, primarily because of the reduced objectives announced in the October 9th letter. This makes good sense for them, since most of them have the ability and motivation to surpass our objectives and I am relieved from pushing for results that I probably can't attain under present conditions.

Some of those who withdrew (and many who didn't) asked me, "What do you really mean?" after receiving the October 9th letter. This sort of a question is a little bruising to any author, but I assured them I meant exactly what I had said. I was also asked whether this was an initial stage in the phasing out of the partnership. The answer to this is, “Definitely, no”. As long as partners want to put up their capital alongside of mine and the business is operationally pleasant (and it couldn't be better), I intend to continue to do business with those who have backed me since tennis shoes.

Gladys Kaiser has joined us and is doing the same sort of top-notch job that we have long received from Donna, Bill and John. The office group, spouses and children have over $15 million invested in BPL on January 1, 1968, so we have not had a need for NoDoz during business hours.

Within a few days, you will receive:

1. A tax letter giving you all BPL information needed for your 1967 federal income tax return. This letter is the only item that counts for tax purposes.

2. An audit from Peat, Marwick, Mitchell & Co. (they have again done an excellent job) for 1967, setting forth the operations and financial position of BPL, as well as your own capital account.

3. A letter signed by me setting forth the status of your BPL interest on January 1, 1968. This is identical with the figures developed in the audit.

Let me know if anything in this letter or that occurs during the year needs clarifying. My next letter will be about July15th, summarizing the first half of this year.

Cordially,

Warren E. Buffett

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July 11th, 1968

First Half Performance

During the first half of 1968, the Dow-Jones Industrial Average declined fractionally from 905 to 898. Ownership of the Dow would also have produced dividends of about $15 during the half, resulting in an overall gain of 0.9% for that Average. The Dow, once again, was an anemic competitor for most investment managers, although it was not surpassed by anything like the margins of 1967.

Our own performance was unusually good during the first half, with an overall gain of 16% excluding any change in valuation for controlled companies (which represented slightly over one-third of net assets at the beginning of the year). However, any release of adrenalin is unwarranted. Our marketable security investments are heavily concentrated in a few situations, making relative performance potentially more volatile than in widely diversified investment vehicles. Our long term performance goals are as stated in the revised "Ground Rules" and I will be quite happy if we achieve those limited objectives over a period of years. The following table summarizes performance to date on the usual basis:

Year	**Overall Results From Dow (1)**	**Partnership Results (2)**	**Limited Partners' Results (3)**
1957	-8.4%	10.4%	9.3%
1958	38.5%	40.9%	32.2%
1959	20.0%	25.9%	20.9%
1960	-6.2%	22.8%	18.6%
1961	22.4%	45.9%	35.9%
1962	-7.6%	13.9%	11.9%
1963	20.6%	38.7%	30.5%
1964	18.7%	27.8%	22.3%
1965	14.2%	47.2%	36.9%
1966	-15.6%	20.4%	16.8%
1967	19.0%	35.9%	28.4%
First Half 1968	0.9%	16.0%	13.5%
Cumulative Results	167.7%	1880.0%	1072.0%
Annual Compounded Rate	8.9%	29.6%	23.8%

(1) Based on yearly changes in the value of the Dow plus dividends that would have been received through ownership of the Dow during that year. The table includes all complete years of partnership activity.

(2) For 1957-61 consists of combined results of all predecessor limited partnerships operating throughout the entire year after all expenses but before distributions to partners or allocations to the general partner.

(3) For 1957-61 computed on the basis of the preceding column of partnership results allowing for allocation to the general partner based upon the present partnership agreement, but before monthly withdrawals by limited partners.

Although we revise valuations of our controlled companies only at yearend, it presently appears that our share of their 1968 earnings will be something over $3 million. Those with primary responsibility for their operations, Ken Chace at Berkshire Hathaway, Louis Kohn at Hochschild Kohn, Jack Ringwalt at National Indemnity and Ben Rosner at Associated Cotton Shops, continue to meld effort and ability into results.

This year, Diversified Retailing Company (owner of Hochschild Kohn and Associated Cotton Shops) issued its first published annual report. This was occasioned by the public sale of debentures to approximately 1,000 investors last December. Thus, DRC is in the rather unusual position of being a public company from a creditors' viewpoint, but a private one (there are three stockholders -BPL owns 80%) for ownership purposes. I am enclosing the DRC report with this letter (except where duplicates go to one house hold) and plan to continue to send them along with future mid-year letters.

As I have mentioned before, we cannot make the same sort of money out of permanent ownership of controlled businesses that can be made from buying and reselling such businesses, or from skilled investment in marketable securities. Nevertheless, they offer a pleasant long term form of activity (when conducted in conjunction with high grade, able people) at satisfactory rates of return.

Investment Companies

On the following page is the form sheet on the usual investment companies:

Year	**Mass. Inv. Trust (1)**	**Investors Stock (1)**	**Lehman (2)**	**Tri-Cont (2)**	**Dow**	**Limited Partners**
1957	-11.4%	-12.4%	-11.4%	-2.4%	-8.4%	9.3%
1958	42.7%	47.5%	40.8%	33.2%	38.5%	32.2%
1959	9.0%	10.3%	8.1%	8.4%	20.0%	20.9%
1960	-1.0%	-0.6%	2.5%	2.8%	-6.2%	18.6%
1961	25.6%	24.9%	23.6%	22.5%	22.4%	35.9%
1962	-9.8%	-13.4%	-14.4%	-10.0%	-7.6%	11.9%
1963	20.0%	16.5%	23.7%	18.3%	20.6%	30.5%
1964	15.9%	14.3%	13.6%	12.6%	18.7%	22.3%
1965	10.2%	9.8%	19.0%	10.7%	14.2%	36.9%
1966	-7.7%	-10.0%	-2.6%	-6.9%	-15.6%	16.8%
1967	20.0%	22.8%	28.0%	25.4%	19.0%	28.4%
First Half 1968	5.1%	2.8%	4.4%	2.0%	0.9%	13.5%
Cumulative Results	**175.7%**	**154.5%**	**218.6%**	**186.7%**	**167.7%**	**1072.0%**
Annual Compounded Rate	**9.2%**	**8.5%**	**10.6%**	**9.6%**	**8.9%**	**23.8%**

(1) Computed from changes in asset value plus any distributions to holders of record during year.
(2) From 1968 Moody's Bank & Finance Manual for 1957 -1967. Estimated for first half of 1968.

Due to a sluggish performance by the Dow in the last few years, the four big funds now have, on average, about a one-half point per annum advantage over the Dow for the full period.

The Present Environment

I make no effort to predict the course of general business or the stock market. Period. However, currently there are practices snowballing in the security markets and business world which, while devoid of short term predictive value, bother me as to possible long term consequences.

I know that some of you are not particularly interested (and shouldn't be) in what is taking place on the financial stage. For those who are, I am enclosing a reprint of an unusually clear and simple article which lays bare just what is occurring on a mushrooming scale. Spectacular amounts of money are being made by those participating (whether as originators, top employees. professional advisors, investment bankers, stock speculators, etc…) in the chain-letter type stock-promotion vogue. The game is being played by the gullible, the self-hypnotized, and the cynical. To create the proper illusions, it frequently requires accounting distortions (one particularly progressive entrepreneur told me he believed in "bold, imaginative accounting"), tricks of capitalization and camouflage of the true nature of the operating businesses involved. The end product is popular, respectable and immensely profitable (I'll let the philosophers figure in which order those adjectives should be placed).

Quite candidly, our own performance has been substantially improved on an indirect basis because of the fall-out from such activities. To create an ever widening circle of chain letters requires increasing amounts of corporate raw material and this has caused many intrinsically cheap (and not so cheap) stocks to come to life. When we have been the owners of such stocks, we have reaped market rewards much more promptly than might otherwise have been the case. The appetite for such companies, however, tends to substantially diminish the number of fundamentally attractive investments which remain.

I believe the odds are good that, when the stock market and business history of this period is being written, the phenomenon described in Mr. May's article will be regarded as of major importance, and perhaps characterized as a mania. You should realize, however, that his "The Emperor Has No Clothes" approach is at odds (or dismissed with a “SO What?” or an "Enjoy, Enjoy”) with the views of most investment banking houses and currently successful investment managers. We live in an investment world, populated not by those who must be logically persuaded to believe, but by the hopeful, credulous and greedy, grasping for an excuse to believe.

Finally, for a magnificent account of the current financial scene, you should hurry out and get a copy of “The Money Game” by Adam Smith. It is loaded with insights and supreme wit. (Note: Despite my current “Support Your Local Postmaster” drive, I am not enclosing the book with this letter - it retails for $6.95.)

Taxes

Several unusual factors make the tax figure even more difficult than usual to estimate this year. We will undoubtedly have an above average amount of ordinary income. The picture on short term and long term capital gain is subject to unusually substantial variance. At the beginning of the year, I suggested that you use an 8% ordinary income factor (it won't come in this manner but this figure embodies an adjustment for long term capital gain) applied to your BPL capital account on an interim basis to compute quarterly tax estimates. If a figure different from 8% seems more appropriate for your September 15th quarterly estimate. I will let you know by September 5th. If no change is necessary, you will next hear from me on November 1st with the Commitment Letter for 1969.

Cordially,

Warren E. Buffett

WEB/glk

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January 22nd, 1969

Our Performance in 1968

Everyone makes mistakes.

At the beginning of 1968, I felt prospects for BPL performance looked poorer than at any time in our history. However, due in considerable measure to one simple but sound idea whose time had come (investment ideas, like women are often more exciting than punctual), we recorded an overall gain of $40,032,691.

Naturally, you all possess sufficient intellectual purity to dismiss the dollar result and demand an accounting of performance relative to the Dow-Jones Industrial Average. We established a new mark at plus 58.8% versus an overall plus 7.7 % for the Dow, including dividends which would have been received through ownership of the Average throughout the year. This result should be treated as a freak like picking up thirteen spades in a bridge game. You bid the slam, make it look modest, pocket the money and then get back to work on the part scores. We will also have our share of hands when we go set.

The following summarizes the year-by-year performance of the Dow, the Partnership before allocation (one quarter of the excess over 6%) to the General Partner and the results for limited partners:

Year	**Overall Results From Dow (1)**	**Partnership Results (2)**	**Limited Partners' Results (3)**
1957	-8.4%	10.4%	9.3%
1958	38.5%	40.9%	32.2%
1959	20.0%	25.9%	20.9%
1960	-6.2%	22.8%	18.6%
1961	22.4%	45.9%	35.9%
1962	-7.6%	13.9%	11.9%
1963	20.6%	38.7%	30.5%
1964	18.7%	27.8%	22.3%
1965	14.2%	47.2%	36.9%
1966	-15.6%	20.4%	16.8%
1967	19.0%	35.9%	28.4%
1968	7.7%	58.8%	45.6%

(1) Based on yearly changes in the value of the Dow plus dividends that would have been received through ownership of the Dow during that year. The table includes all complete years of Partnership activity.

(2) For 1957-61 consists of combined results of all predecessor limited partnerships operating throughout the entire year after all expenses, but before distributions to partners or allocations to the General Partner.

(3) For 1957-61 computed on the basis of the preceding column of Partnership results allowing for allocation to the General Partner based upon the present Partnership Agreement, but before monthly withdrawals by limited partners.

On a cumulative or compounded basis, the results are:

Year	Overall Results From Dow	Partnership Results	Limited Partners' Results
1957	-8.4%	10.4%	9.3%
1957 – 58	26.9%	55.6%	44.5%
1957 – 59	52.3%	95.9%	74.7%
1957 – 60	42.9%	140.6%	107.2%
1957 – 61	74.9%	251.0%	181.6%
1957 – 62	61.6%	299.8%	215.1%
1957 – 63	95.1%	454.5%	311.2%
1957 – 64	131.3%	608.7%	402.9%
1957 – 65	164.1%	943.2%	588.5%
1957 – 66	122.9%	1156.0%	704.2%
1957 – 67	165.3%	1606.9%	932.6%
1957 – 68	185.7%	2610.6%	1403.5%
Annual Compounded Rate	**9.1%**	**31.6%**	**25.3%**

Investment Companies

On the following page is the usual tabulation showing the results of what were the two largest mutual funds (they stood at the top in size from 1957 through 1966 - they are still number two and three) that follow a policy of being, typically, 95 -100% invested in common stocks, and the two largest diversified closed-end investment companies.

Year	Mass. Inv. Trust (1)	Investors Stock (1)	Lehman (2)	Tri-Cont (2)	Dow	Limited Partners
1957	-11.4%	-12.4%	-11.4%	-2.4%	-8.4%	9.3%
1958	42.7%	47.5%	40.8%	33.2%	38.5%	32.2%
1959	9.0%	10.3%	8.1%	8.4%	20.0%	20.9%
1960	-1.0%	-0.6%	2.5%	2.8%	-6.2%	18.6%
1961	25.6%	24.9%	23.6%	22.5%	22.4%	35.9%
1962	-9.8%	-13.4%	-14.4%	-10.0%	-7.6%	11.9%
1963	20.0%	16.5%	23.7%	18.3%	20.6%	30.5%
1964	15.9%	14.3%	13.6%	12.6%	18.7%	22.3%
1965	10.2%	9.8%	19.0%	10.7%	14.2%	36.9%
1966	-7.7%	-10.0%	-2.6%	-6.9%	-15.6%	16.8%
1967	20.0%	22.8%	28.0%	25.4%	19.0%	28.4%
1968	10.3%	8.1%	6.7%	6.8%	7.7%	45.6%
Cumulative Results	**189.3%**	**167.7%**	**225.6%**	**200.2%**	**185.7%**	**1403.5%**
Annual Compounded Rate	**9.3%**	**8.6%**	**10.3%**	**9.6%**	**9.1%**	**25.3%**

(1) Computed from changes in asset value plus any distributions to holders of record during year.
(2) From 1968 Moody's Bank & Finance Manual for 1957-1967. Estimated for 1968.

It is interesting that after twelve years these four funds (which presently aggregate well over $5 billion and account for over 10% of the investment company industry) have averaged only a fraction of one percentage point annually better than the Dow.

Some of the so-called "go-go" funds have recently been re-christened "no-go" funds. For example, Gerald Tsai's Manhattan Fund, perhaps the world's best-known aggressive investment vehicle, came in at minus 6.9% for 1968. Many smaller investment entities continued to substantially outperform the general market in 1968, but in nothing like the quantities of 1966 and 1967.

The investment management business, which I used to severely chastise in this section for excessive lethargy, has now swung in many quarters to acute hypertension. One investment manager, representing an organization (with an old established name you would recognize) handling mutual funds aggregating well over $1 billion, said upon launching a new advisory service in 1968:

> "The complexities of national and international economics make money management a full-time job. A good money manager cannot maintain a study of securities on a week-by-week or even a day-by-day basis. Securities must be studied in a minute-by-minute program."

Wow!

This sort of stuff makes me feel guilty when I go out for a Pepsi. When practiced by large and increasing numbers of highly motivated people with huge amounts of money on a limited quantity of suitable securities, the result becomes highly unpredictable. In some ways it is fascinating to watch and in other ways it is appalling.

Analysis of 1968 Results

All four main categories of our investment operation worked out well in 1968. Our total overall gain of $40,032,691 was divided as follows:

Category	**Average Investment**	**Overall Gain**
Controls	$24,996,998	$5,886,109
Generals – Private Owner	$16,363,100	$21,994,736
Generals – Relatively Undervalued	$8,766,878	$4,271,825
Workouts	$18,980,602	$7,317,128
Miscellaneous, primarily US Treasury Bills	$12,744,973	$839,496
Total Income		$40,309,294
Less – General Expense, including Interest		$276,603
Overall Gain		$40,032,691

A few caveats, as mentioned in my letter two years ago, are again in order (non-doctoral candidates may proceed to next section):

1. An explanation of the various categories listed above was made in the January 18, 1965 letter. If your memory needs refreshing and your favorite newsstand does not have the pocketbook edition. We'll be glad to give you a copy.

2. The classifications are not iron clad. Nothing is changed retroactively, but the initial decision as to category is sometimes arbitrary. Sometimes later classification proves difficult; e.g. a workout that falls

through but that I continue to hold for reasons unrelated or only partially related to the original decision (like stubbornness).

3. Percentage returns calculated on the average investment base by category would be significantly understated relative to Partnership percentage returns which are calculated on a beginning investment base. In the foregoing figures, a security purchased by us at 100 on January 1 which appreciated at an even rate to 200 on December 31 would have an average investment of 150 producing a 66-2/3% result contrasted to a 100% result by the customary approach. In other words, the foregoing figures use a monthly average of market values in calculating the average investment.

4. All results are based on a 100% ownership, non-leverage basis. Interest and other general expenses are deducted from total performance and not segregated by category. Expenses directly related to specific investment operations, such as dividends paid on short stock, are deducted by category. When securities are borrowed directly and sold short, the net investment (longs minus shorts) is shown for the applicable category's average investment.

5. The foregoing table has only limited use. The results applicable to each category are dominated by one or two investments. They do not represent a collection of great quantities of stable data (mortality rates of all American males or something of the sort) from which conclusions can be drawn and projections made. Instead, they represent infrequent, non-homogeneous phenomena leading to very tentative suggestions regarding various courses of action and are so used by us.

6. Finally, these calculations are not made with the same loving care we apply to counting the money and are subject to possible clerical or mathematical error since they are not entirely se1f-checking.

<u>Controls</u>

Overall, the controlled companies turned in a decent performance during 1968. Diversified Retailing Company Inc. (80% owned) and Berkshire Hathaway Inc. (70% owned) had combined after-tax earnings of over $5 million.

Particularly outstanding performances were turned in by Associated Cotton Shops, a subsidiary of DRC run by Ben Rosner, and National Indemnity Company, a subsidiary of B-H run by Jack Ringwalt. Both of these companies earned about 20% on capital employed in their businesses. Among Fortune's “500” (the largest manufacturing entities in the country, starting with General Motors), only 37 companies achieved this figure in 1967, and our boys outshone such mildly better-known (but not better appreciated) companies as IBM, General Electric, General Motors, Procter & Gamble, DuPont, Control Data, Hewlett-Packard, etc...

I still sometimes get comments from partners like: "Say, Berkshire is up four points - that's great!" or "What's happening to us, Berkshire was down three last week?" Market price is irrelevant to us in the valuation of our controlling interests. We valued B-H at 25 at yearend 1967 when the market was about 20 and 31 at yearend 1968 when the market was about 37. We would have done the same thing if the markets had been 15 and 50 respectively. ("Price is what you pay. value is what you get"). We will prosper or suffer in controlled investments in relation to the operating performances of our businesses - we will not attempt to profit by playing various games in the securities markets.

<u>Generals -Private Owner</u>

Over the years this has been our best category, measured by average return, and has also maintained by far the best percentage of profitable transactions. This approach was the way I was taught the business, and it formerly accounted for a large proportion of all our investment ideas. Our total individual profits in this category during the twelve year BPL history are probably fifty times or more our total losses. The cash register really rang on one simple industry idea (implemented in several ways) in this area in 1968. We even received a substantial fee (included in Other Income in the audit) for some work in this field.

Our total investment in this category (which is where I feel by far the greatest certainty regarding consistently decent results) is presently under $2 million and I have nothing at all in the hopper to bolster this. What came through like the Johnstown flood in 1968 looks more like a leaky faucet in Altoona for 1969.

Generals - Relatively Undervalued

This category produced about two-thirds of the overall gain in 1966 and 1967 combined. I mentioned last year that the great two-year performance here had largely come from one idea. I also said, "We have nothing in this group remotely approaching the size or potential which formerly existed in this investment." It gives me great pleasure to announce that this statement was absolutely correct. It gives me somewhat less pleasure to announce that it must be repeated this year.

Workouts

This category, which was a disaster in 1967, did well during 1968. Our relatively heavy concentration in just a few situations per year (some of the large arbitrage houses may become involved in fifty or more workouts per annum) gives more variation in yearly results than an across-the-board approach. I feel the average profitability will be as good with our policy and 1968 makes me feel better about that conclusion than 1967 did.

It should again be stated that our results in the Workout area (as well as in other categories) are somewhat understated compared to the more common method of determining results computed on an initial base figure and utilizing borrowed money (which is often a sensible part of the Workout business).

****

I can't emphasize too strongly that the quality and quantity of ideas is presently at an all time low - the product of the factors mentioned in my October 9th, 1967 letter, which have largely been intensified since then.

Sometimes I feel we should have a plaque in our office like the one at the headquarters of Texas Instruments in Dallas which reads: “We don't believe in miracles, we rely on them.” It is possible for an old, overweight ball player, whose legs and batting eye are gone, to tag a fast ball on the nose for a pinch-hit home run, but you don't change your line-up because of it.

We have a number of important negatives operating on our future and, while they shouldn't add up to futility, they certainly don't add up to more than an average of quite moderate profitability.

Memorabilia

As one of my older friends says, “Nostalgia just isn't what it used to be.” Let's take a stab at it, anyway.

Buffett Associates, Ltd., the initial predecessor partnership, was formed May 5, 1956 with seven limited partners (four family, three close friends), contributing $105,000, and the General Partner putting his money where his mouth was by investing $100. Two additional single-family limited partnerships were formed during 1956, so that on January 1, 1957 combined net assets were $303,726. During 1957, we had a gain of $31,615.97, leading to the 10.4% figure shown on page one. During 1968 I would guess that the New York Stock Exchange was open around 1,200 hours, giving us a gain of about $33,000 per hour (sort of makes you wish they had stayed with the 5-1/2 hour, 5 day week, doesn't it), or roughly the same as the full year gain in 1957.

On January 1, 1962 we consolidated the predecessor limited partnerships moved out of the bedroom and hired our first full-time employees. Net assets at that time were $7,178,500. From that point to our present net assets of $104,429,431 we have added one person to the payroll. Since 1963 (Assets $9,405,400) rent has gone from $3,947 to $5,823 (Ben Rosner would never have forgiven me if I had signed a percentage lease) travel from $3,206 to $3,603, and dues and subscriptions from $900 to $994. If one of Parkinson's Laws is operating, at least the situation hasn't gotten completely out of control.

In making our retrospective survey of our financial assets, our conclusion need not parallel that of Gypsy Rose Lee who opined, when reviewing her physical assets on her fifty-fifth birthday: “I have everything I had twenty years ago - it's just that it's all lower.”

Miscellaneous

Although the investment environment is difficult, the office environment is superb. With Donna, Gladys, Bill and John, we have an organization that functions speedily, efficiently and pleasantly. They are the best.

The office group, along with spouses (one apiece - I still haven't figured out how I should handle that plural) and children have over $27 million invested in BPL on January 1, 1969. Assorted sizes and shapes of aunts, uncles, parents, in-laws, brothers, sisters and cousins make the BPL membership list read like “Our Crowd” - which, so far as I am concerned, is exactly what it is.

Within a few days, you will receive:

1. A tax letter giving you all BPL information needed for your 1968 federal income tax return. This letter is the only item that counts for tax purposes.

2. An audit from Peat Marwick. Mitchell & Co. (they have again done an excellent job) for 1968, setting forth the operations and financial position of BPL, as well as your own capital account.

3. A letter signed by me setting forth the status of your BPL interest on January 1, 1969. This is identical with the figures developed in the audit.

Let me know if anything in this letter or that occurs during the year needs clarifying. My next letter will be about July 10th, summarizing the first half of this year.

Cordially,

Warren E. Buffett

WEB/glk

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May 29th, 1969

To My Partners:

About eighteen months ago I wrote to you regarding changed environmental and personal factors causing me to modify our future performance objectives.

The investing environment I discussed at that time (and on which I have commented in various other letters has generally become more negative and frustrating as time has passed. Maybe I am merely suffering from a lack of mental flexibility. (One observer commenting on security analysts over forty stated: “They know too many things that are no longer true.”)

However, it seems to me that: (1) opportunities for investment that are open to the analyst who stresses quantitative factors have virtually disappeared, after rather steadily drying up over the past twenty years; (2) our $100 million of assets further eliminates a large portion of this seemingly barren investment world, since commitments of less than about $3 million cannot have a real impact on our overall performance, and this virtually rules out companies with less than about $100 million of common stock at market value; and (3) a swelling interest in investment performance has created an increasingly short-term oriented and (in my opinion) more speculative market.

The October 9th, 1967 letter stated that personal considerations were the most important factor among those causing me to modify our objectives. I expressed a desire to be relieved of the (self-imposed) necessity of focusing 100% on BPL. I have flunked this test completely during the last eighteen months. The letter said: I hope limited objectives will make for more limited effort. It hasn't worked out that way. As long as I am “on stage”, publishing a regular record and assuming responsibility for management of what amounts to virtually 100% of the net worth of many partners, I will never be able to put sustained effort into any non-BPL activity. If I am going to participate publicly. I can't help being competitive. I know I don't want to be totally occupied with out-pacing an investment rabbit all my life. The only way to slow down is to stop.

Therefore, before yearend. I intend to give all limited partners the required formal notice of my intention to retire. There are, of course, a number of tax and legal problems in connection with liquidating the Partnership, but overall, I am concerned with working out a plan that attains the following objectives:

1. The most important item is that I have an alternative regarding money management to suggest to the many partners who do not want to handle this themselves. Some partners of course, have alternatives of their own in which they have confidence and find quite acceptable. To the others, however, I will not hand over their money with a "good luck". I intend to suggest an alternative money manager to whom I will entrust funds of my relatives and others for whom I have lifetime financial responsibility. This manager has integrity and ability and will probably perform as well or better than I would in the future (although nowhere close to what he or I have achieved in the past). He will be available to any partner, so that no minimum size for accounts will cause any of you a problem. I intend, in the future, to keep in general touch with what he is doing, but only on an infrequent basis with any advice on my part largely limited to a negative type.

2. I want all partners to have the option of receiving cash and possibly readily marketable securities (there will probably be only one where this will apply) where I like both the prospects and price but which

partners will be able to freely convert to cash if they wish.

3. However, I also want all partners to have the option of maintaining their proportional interests in our two controlled companies (Diversified Retailing Company Inc. and Berkshire Hathaway Inc.) and one other small "restricted" holding. Because these securities will be valued unilaterally by me at fair value, I feel it is essential that, if you wish, you can maintain your proportionate interest at such valuation.

    However, these securities are not freely marketable (various SEC restrictions apply to “control” stock and non-registered stock) and they will probably be both non-transferable and non-income - producing for a considerable period of time. Therefore, I want you to be able to go either way in our liquidation - either stick with the restricted securities or take cash equivalent. I strongly like all of the people running our controlled businesses (joined now by the Illinois National Bank and Trust Company of Rockford, Illinois, a $100 million plus, extremely well-run bank, purchased by Berkshire Hathaway earlier this year), and want the relationship to be life long. I certainly have no desire to sell a good controlled business run by people I like and admire, merely to obtain a fancy price. However, specific conditions may cause the sale of one operating unit at some point.

I believe we will have a liquidation program which will accomplish the above objectives. Our activities in this regard should cause no change in your tax planning for 1969.

One final objective, I would like very much to achieve (but which just isn't going to happen) is to go out with a bang. I hate to end with a poor year, but we are going to have one in 1969. My best guess is that at yearend, allowing for a substantial increase in value of controlled companies (against which all partners except me will have the option of taking cash), we will show a breakeven result for 1969 before any monthly payments to partners. This will be true even if the market should advance substantially between now and yearend, since we will not be in any important position which will expose us to much upside potential.

Our experience in workouts this year has been atrocious - during this period I have felt like the bird that inadvertently flew into the middle of a badminton game. We are not alone in such experience, but it came at a time when we were toward the upper limit of what has been our historical range of percentage commitment in this category.

Documenting one's boners is unpleasant business. I find "selective reporting" even more distasteful. Our poor experience this year is 100% my fault. It did not reflect bad luck, but rather an improper assessment of a very fast-developing governmental trend. Paradoxically, I have long believed the government should have been doing (in terms of the problem attacked – not necessarily the means utilized) what it finally did - in other words, on an overall basis, I believe the general goal of the activity which has cost us substantial money is socially desirable and have so preached for some time. Nevertheless, I didn't think it would happen. I never believe in mixing what I think should happen (socially) with what I think will happen in making decisions - in this case, we would be some millions better off if I had.

Quite frankly, in spite of any factors set forth on the earlier pages. I would continue to operate the Partnership in 1970, or even 1971, if I had some really first class ideas. Not because I want to, but simply because I would so much rather end with a good year than a poor one. However. I just don't see anything available that gives any reasonable hope of delivering such a good year and I have no desire to grope around, hoping to "get lucky" with other people's money. I am not attuned to this market environment and I don't want to spoil a decent record by trying to play a game I don't understand just so I can go out a hero.

Therefore, we will be liquidating holdings throughout the year, working toward a residual of the controlled companies, the one "investment letter" security, the one marketable security with favorable long-term prospects, and the miscellaneous "stubs", etc. of small total value which will take several years to clean up in the Workout category.

I have written this letter a little early in lieu of the mid-year letter. Once I made a decision, I wanted you to know. I also wanted to be available in Omaha for a period after you received this letter to clear up anything that may be confusing in it. In July, I expect to be in California.

Some of you are going to ask, "What do you plan to do?" I don't have an answer to that question. I do know that when I am 60, I should be attempting to achieve different personal goals than those which had priority at age 20. Therefore, unless I now divorce myself from the activity that has consumed virtually all of my time and energies during the first eighteen years of my adult life, I am unlikely to develop activities that will be appropriate to new circumstances in subsequent years.

We will have a letter out in the Fall, probably October, elaborating on the liquidation procedure, the investment advisor suggestion, etc…

Cordially,

Warren E. Buffett

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October 9th, 1969

To My Partners:

Here is my present estimate of the BPL calendar for the months to come:

(1) This letter - to tell you something of Bill Ruane, the money manager within my knowledge who ranks the highest when combining the factors of integrity, ability and continued availability to all partners. I also want to comment upon the present range of expectations involved in deciding on a bond-stock mix.

(2) Late November - the required thirty days formal notice of my intent to retire from the Partnership at the end of the year.

(3) Early December - a package of publicly available material, as well as some general comments by me relating to our controlled companies. Berkshire Hathaway Inc. (owning the textile business, Illinois National Bank and Trust Company of Rockford, Illinois, National Indemnity Company and National Fire and Marine Insurance Company and Sun Newspapers) and Diversified Retailing Company (owning Hochschild, Kohn & Co. and Associated Cotton Shops). I want you to have ample time to study the material relating to such companies before you make any decision to hold, sell or buy such securities after distribution to you in early January. I will solicit written questions from partners (I don't want to talk to you individually about such companies, as I want all partners to obtain exactly the same information) and then have a further mailing late in December, giving all questions received relating to these companies along with my answers, if possible. I still anticipate having a plan enabling partners to promptly convert such controlled company holdings to cash, if they wish.

(4) About January 5th - (a) a cash distribution amounting to at least 56% (probably more - depending upon what percentage of our remaining holdings are sold before yearend) of your January 1, 1969 capital, less any distributions (the regular monthly payments many of you receive) or borrowings by you during 1969, (b) your proportional share of our holdings in Diversified Retailing Company Inc. and Berkshire Hathaway Inc. I which, if you dispose of them, will bring 30% - 35% (my estimate of value will be made at yearend) of your January 1, 1969 capital.

    We may make substantial additional sales before yearend - if so, the early January cash distribution will be somewhat larger than the 56% mentioned above. If we don't, such sales will be made during the first half of 1970 and an interim distribution made. Residual assets will be sold at appropriate times and I believe not more than 10% of our present asset value will remain after June 30th, 1970 pending a final distribution when all assets and liabilities have been cleaned up.

    Unless there is a further substantial decline in the market. I still expect about a breakeven performance before any monthly payments for 1969. We were lucky - if we had not been in liquidation this year, our results would have been significantly worse. Ideas that looked potentially interesting on a "continuing" basis have on balance performed poorly to date. We have only two items of real size left - one we are selling as I write this and the other is a holding of limited marketability representing about 7-1/2% of the outstanding stock of Blue Chip Stamps which we may sell via a registered public offering around yearend, depending upon market conditions and other factors.

(5) March 1st. 1970 - John Harding expects to leave Buffett Partnership. Ltd. and open a branch office in Omaha for Ruane, Cunniff & Stires. Bill Scott and I will be available at BPL offices to help any partners who are desirous of purchasing bonds, tax-free or taxable. We will set aside the month of March to make our services available without cost to those who want to acquire bonds. Because of some experience we have in analysis and purchasing, as well as the access we have to wholesale markets. I think it is likely we can save material elements of cost as well as help select better relative values for those of you who wish to invest in bonds. After April 1st, however, we want to be out of any form of personal advisory activity.

(6) After March, 1970 - Bill and I will continue to office in Kiewit Plaza, spending a very minor portion of our time completing the wind-up of BPL. This will mean filing tax returns for 1970 and probably 1971 resolving minor assets and liabilities etc.

Now, to Bill Ruane - we met in Ben Graham's class at Columbia University in 1951 and I have had considerable opportunity to observe his qualities of character, temperament and intellect since that time. If Susie and I were to die while our children are minors, he is one of three trustees who have carte blanche on investment matters - the other two are not available for continuous investment management for all partners, large or small.

There is no way to eliminate the possibility of error when judging humans particularly in regard to future behavior in an unknown environment. However, decisions have to be made - whether actively or passively - and I consider Bill to be an exceptionally high probability decision on character and a high probability one on investment performance. I also consider it likely that Bill will continue as a money manager for many years to come.

Bill has recently formed a New York Stock Exchange firm, Ruane, Cunniff & Stires, Inc., 85 Broad Street, New York, N.Y. 10004, telephone number (212) 344-6700. John Harding presently plans to establish an office for the firm in Omaha about March 1st, 1970. Bill manages accounts individually on a fee basis and also executes brokerage for the accounts - presently with some portion of the brokerage commissions used to offset a portion of the investment advisory fee. His method of operation allows monthly withdrawals on a basis similar to BPL - as a percentage of capital and unrelated to realized or unrealized gain or loss. It is possible he may form some sort of pooled account but such determinations will be made between him and those of you who elect to go with him. I, of course, will not be involved with his operation. I am making my list of partners available to him and he will be writing you fairly soon regarding a trip he plans to make before yearend to Omaha, Los Angeles and Chicago, so that those of you who wish to meet him may do so. Any of you who are going to be in New York during the next few months can contact him directly.

Bill's overall record has been very good-averaging fairly close to BPL's, but with considerably greater variation. From 1956-1961 and from 1964-1968, a composite of his individual accounts averaged over 40% per annum. However, in 1962, undoubtedly somewhat as a product of the euphoric experience of the earlier years, he was down about 50%. As he re-oriented his thinking, 1963 was about breakeven.

While two years may sound like a short time when included in a table of performance, it may feel like a long time when your net worth is down 50%. I think you run this sort of short-term risk with virtually any money manager operating in stocks and it is a factor to consider in deciding the portion of your capital to commit to equities. To date in 1969, Bill is down about 15%, which I believe to be fairly typical of most money managers. Bill, of course, has not been in control situations or workouts, which have usually tended to moderate the swings in BPL year-to-year performance. Even excluding these factors, I believe his performance would have been somewhat more volatile (but not necessarily poorer by any means) than mine - his style is different, and while his typical portfolio (under most conditions) would tend to have a mild overlap with mine, there would always be very significant differences.

Bill has achieved his results working with an average of $5 to $10 million. I consider the three most likely negative factors in his future to be: (1) the probability of managing significantly larger sums - this is a problem you are going to have rather quickly with any successful money manager, and it will tend to moderate performance; I believe Bill's firm is now managing $20 -$30 million and, of course, they will continue to add accounts; (2) the possibility of Bill's becoming too involved in the detail of his operation rather than spending all of his time simply thinking about money management. The problems of being the principal factor in a NYSE firm as well as handling many individual accounts can mean that he, like most investment advisors, will be subject to pressures to spend much of his time in activities that do nothing to lead to superior investment performance. In this connection, I have asked Bill to make his services available to all BPL partners - large or small and he will, but I have also told him he is completely a free agent if he finds particular clients diverting him from his main job; (3) the high probability that even excellent investment management during the next decade will only produce limited advantages over passive management. I will comment on this below.

The final point regarding the negatives listed above is that they are not the sort of drawbacks leading to horrible performance, but more likely the sort of things that lead to average performance. I think this is the main risk you run with Bill - and average performance is just not that terrible a risk.

In recommending Bill, I am engaging in the sort of activity I have tried to avoid in BPL portfolio activities - a decision where there is nothing to gain (personally) and considerable to lose. Some of my friends who are not in the Partnership have suggested that I make no recommendation since, if results were excellent it would do me no good and, if something went wrong, I might well get a portion of the blame. If you and I had just had a normal commercial relationship, such reasoning might be sound. However, the degree of trust partners have extended to me and the cooperation manifested in various ways precludes such a "hands off" policy. Many of you are professional investors or close thereto and need no advice from me on managers - you may well do better yourself. For those partners who are financially inexperienced. I feel it would be totally unfair for me to assume a passive position and deliver you to the most persuasive salesman who happened to contact you early in 1970.

Finally, a word about expectations. A decade or so ago was quite willing to set a target of ten percentage points per annum better than the Dow, with the expectation that the Dow would average about 7%. This meant an expectancy for us of around 17%, with wide variations and no guarantees, of course - but, nevertheless, an expectancy. Tax-free bonds at the time yielded about 3%. While stocks had the disadvantage of irregular performance, overall they seemed much the more desirable option. I also stressed this preference for stocks in teaching classes, participating in panel discussions, etc…

For the first time in my investment lifetime. I now believe there is little choice for the average investor between professionally managed money in stocks and passive investment in bonds. If correct. this view has important implications. Let me briefly (and in somewhat oversimplified form) set out the situation as I see it:

(1) I am talking about the situation for, say, a taxpayer in a 40% Federal Income Tax bracket who also has some State Income Tax to pay. Various changes are being proposed in the tax laws, which may adversely affect net results from presently tax-exempt income, capital gains, and perhaps other types of investment income. More proposals will probably come in the future. Overall, I feel such changes over the years will not negate my relative expectations about after-tax income from presently tax-free bonds versus common stocks, and may well even mildly reinforce them.

(2) I am talking about expectations over the next ten years - not the next weeks or months. I find it much easier to think about what should develop over a relatively long period of time than what is likely in any short period. As Ben Graham said: “In the long run, the market is a weighing machine - in the short run, a voting machine.” I have always found it easier to evaluate weights dictated by fundamentals than votes dictated by psychology.

(3) Purely passive investment in tax-free bonds will now bring about 6-1/2%. This yield can be achieved with excellent quality and locked up for just about any period for which the investor wishes to contract. Such conditions may not exist in March when Bill and I will be available to assist you in bond purchases, but they exist today.

(4) The ten year expectation for corporate stocks as a group is probably not better than 9% overall. say 3% dividends and 6% gain in value. I would doubt that Gross National Product grows more than 6% per annum - I don't believe corporate profits are likely to grow significantly as a percentage of GNP - and if earnings multipliers don't change (and with these assumptions and present interest rates they shouldn't) the aggregate valuation of American corporate enterprise should not grow at a long-term compounded rate above 6% per annum. This typical experience in stocks might produce (for the taxpayer described earlier) 1-3/4% after tax from dividends and 4-3/4% after tax from capital gain, for a total after-tax return of about 6-1/2%. The pre-tax mix between dividends and capital gains might be more like 4% and 5%, giving a slightly lower aftertax result. This is not far from historical experience and overall, I believe future tax rules on capital gains are likely to be stiffer than in the past.

(5) Finally, probably half the money invested in stocks over the next decade will be professionally managed. Thus, by definition virtually, the total investor experience with professionally managed money will be average results (or 6-1/2% after tax if my assumptions above are correct).

My judgment would be that less than 10% of professionally managed money (which might imply an average of $40 billion just for this superior segment) handled consistently for the decade would average 2 points per annum over group expectancy. So-called "aggressively run" money is unlikely to do significantly better than the general run of professionally managed money. There is probably $50 billion in various gradations of this "aggressive" category now - maybe 100 times that of a decade ago - and $50 billion just can't "perform".

If you are extremely fortunate and select advisors who achieve results in the top 1% to 2% of the country (but who will be working with material sums of money because they are that good), I think it is unlikely you will do much more than 4 points per annum better than the group expectancy. I think the odds are good that Bill Ruane is in this select category. My estimate . therefore, is that over the next decade the results of really excellent management for our "typical taxpayer" after tax might be 1-3/4% from dividends and 7-3/4% from capital gain. or 9 –1.2% overall.

(6) The rather startling conclusion is that under today's historically unusual conditions, passive investment in tax-free bonds is likely to be fully the equivalent of expectations from professionally managed money in stocks, and only modestly inferior to extremely well-managed equity money.

(7) A word about inflation - it has very little to do with the above calculation except that it enters into the 6% assumed growth rate in GNP and contributes to the causes producing 6-1/2% on tax-free bonds. If stocks should produce 8% after tax and bonds 4%, stocks are better to own than bonds, regardless of whether prices go up, down or sidewise. The converse is true if bonds produce 6-1/2% after tax. and stocks 6%. The simple truth, of course, is that the best expectable after-tax rate of return makes the most sense - given a rising, declining or stable dollar.

All of the above should be viewed with all the suspicion properly accorded to assessments of the future. It does seem to me to be the most realistic evaluation of what is always an uncertain future - I present it with no great feeling regarding its approximate accuracy, but only so you will know what I think at this time.

You will have to make your own decision as between bonds and stocks and, if the latter, who advises you on such stocks. In many cases, I think the decision should largely reflect your tangible and intangible (temperamental) needs for regularity of income and absence of large principal fluctuation, perhaps balanced against psychic needs for some excitement and the fun associated with contemplating and perhaps enjoying really juicy results. If you would like to talk over the problem with me, I will be very happy to help.

Sincerely,

Warren E. Buffett

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December 5th, 1969

To My Partners:

This letter is to supply you with some published information relating to our two controlled companies (and their four principal operating components), as well as to give you my general views regarding their operations. My comments are not designed to give you loads of detailed information prospectus-style, but only my general "slant" as I see the businesses at this time.

At yearend, BPL will own 800,000 of 1,000,000 shares outstanding of Diversified Retailing Company. First Manhattan Company and Wheeler, Munger & Company will each own 100,000 shares. DRC previously owned 100% of Hochschild, Kohn & Company of Baltimore, and currently owns 100% of Associated Retail Stores (formerly named Associated Cotton Shops). On December 1st, DRC sold its entire interest in H-K to Supermarkets General Corp. for $5,045,205 of cash plus non-interest bearing SGC notes for $2 million due 2-1-70, and $4,540,000 due 2-1-71. The present value of these notes approximates $6.0 million so, effectively, DRC received about $11 million on the sale. Various warranties were made by DRC in connection with the sale, and, while we expect no claims pursuant to the contract, a remote contingent liability always exists while warranties are in force.

Associated Retail Stores has a net worth of about $7.5 million. It is an excellent business with a strong financial position, good operating margins and a record of increasing sales and earnings in recent years. Last year, sales were about $37.5 million and net income about $1 million. This
year should see new records in sales and earnings, with my guess on the latter to be in the area of $1.1 million after full taxes.

DRC has $6.6 million in debentures outstanding (prospectus with full description of the business as of December 18th, 1967 and the debenture terms will be sent you upon request) which have one unusual feature in that if I, or an entity controlled by me, is not the largest shareholder of DRC, the debentureholders have the right to present their debentures for payment by the company at par.

Thus, DRC has tangible net assets of about $11.50 - $12.00 per share, an excellent operating business and substantial funds available for reinvestment in other operating businesses. On an interim basis, such funds will be employed in marketable securities.

Berkshire Hathaway Inc. has 983,582 shares outstanding, of which BPL owns 691,441. B-H has three main operating businesses, the textile operation, the insurance operation (conducted by National Indemnity Company and National Fire & Marine Insurance Company, which will be collectively called the insurance company) and the Illinois National Bank and Trust Company of Rockford, Illinois. It also owns Sun Newspapers Inc, Blacker Printing Company and 70% of Gateway Underwriters, but these operations are not financially significant relative to the total.

The textile operation presently employs about $16 per share in capital and, while I think it has made some progress relative to the textile industry generally, cannot be judged a satisfactory business. Its return on capital has not been sufficient to support the assets employed in the business and, realistically, an adequate return has less than an even chance of being averaged in the future. It represents the best segments of the business that existed when we purchased control four and one-half years ago. Capital from the other segments has been successfully redeployed - first, on an interim basis into marketable securities and, now on a permanent basis into insurance and banking. I like the textile operating people - they have worked hard to improve the business under difficult conditions - and, despite the poor return, we expect to continue the textile operation as long as it produces near current levels.

The insurance operation (of which B-H owns virtually 100%) and the bank (where B-H owns 97.7%) present a much happier picture. Both are first-class businesses, earning good returns on capital and stacking up well on any absolute or comparative analysis of operating statistics. The bank has about $17 per share of net tangible assets applicable to B-H, and the insurance company approximately $15. I would estimate their normal current earning power to be about $4 per share (compared to about $3.40 from operations pro-forma in 1968), with good prospects for future growth on the combined $32 of tangible net assets in the bank and insurance company. Adding in the textile business and miscellaneous assets, and subtracting parent company bank debt of about $7 million, gives a tangible net asset value of about $43 per share for B-H, or about $45 stated book value, allowing for the premium over tangible assets paid for the bank.

One caveat - when I talk above of tangible net assets. I am valuing the $75 million of bonds held by the insurance company and bank at amortized cost. This is in accord with standard accounting procedures used in those industries and also in accord with the realities of their business operations where it is quite unlikely that bonds will have to be sold before maturity. At today's historically low bond prices, however, our bonds have a market value substantially below carrying value, probably on the order of $10 per share of B-H stock.

Between DRC and B-H, we have four main operating businesses with three of them in my opinion, definitely first class by any of the usual standards of evaluation. The three excellent businesses are all run by men over sixty who are largely responsible for building each operation from scratch. These men are hard working, wealthy, and good – extraordinarily good. Their age is a negative, but it is the only negative applicable to them. One of the reasons I am happy to have a large segment of my capital in B-H and DRC is because we have such excellent men in charge of the operating businesses.

We have various annual reports, audits, interim reports, proxy materials prospectuses, etc… applicable to our control holdings and we will be glad to supply you with any item you request. I also solicit your written questions and will send to all partners the questions and answers shortly before yearend. Don't hesitate to ask any question at all that comes to mind - if it isn't clear to you, it probably isn't clear to others - and there is no reason for any of you to be wondering about something that I might clear up.

DRC and B-H presently pay no dividends and will probably pay either no dividends or very modest dividends for some years to come. There are a number of reasons for this. Both parent companies have borrowed money - we want to maintain a good level of protection for depositors at the bank and policyholders at the insurance company - some of the operating companies have very satisfactory ways to utilize additional capital - and we are hopeful of finding new businesses to both diversify and augment our earning power.

My personal opinion is that the intrinsic value of DRC and B-H will grow substantially over the years. While no one knows the future, I would be disappointed if such growth wasn't at a rate of approximately 10% per annum. Market prices for stocks fluctuate at great amplitudes around intrinsic value but, over the long term, intrinsic value is virtually always reflected at some point in market price. Thus, I think both securities should be very decent long-term holdings and I am happy to have a substantial portion of my net worth invested in them. You should be unconcerned about short-term price action when you own the securities directly, just as you were unconcerned when you owned them indirectly through BPL. I think about them as businesses, not "stocks", and if the business does all right over the long term, so will the stock.

I want to stress that I will not be in a managerial or partnership status with you regarding your future holdings of such securities. You will be free to do what you wish with your stock in the future and so, of course, will I. I think that there is a very high probability that I will maintain my investment in DRC and B-H for a very long period, but I want no implied moral commitment to do so nor do so nor do I wish to advise others over an indefinite future period regarding their holdings. The companies, of course, will keep all shareholders advised of their activities and you will receive reports as issued by them, probably on a semi-annual basis. Should I continue to hold the securities, as I fully expect to do, my degree of involvement in their activities may vary depending upon my other interests. The odds are that I will take an important position on matters of policy, but I want no moral obligation to be other than a passive shareholder, should my interests develop elsewhere.

We presently plan to make the initial BPL cash distribution on January 5th, which will now come to at least 64% of January 1, 1969 capital less any distributions (including monthly payments) you have received from us since January 1, 1969. There is now pending a public offering, headed by Merrill, Lynch, Pierce, Fenner & Smith, of our Blue Chip Stamps holdings which, if completed this month as expected, should bring the figure to at least 70%.

If you wish Bill and me to give you our ideas regarding bonds in March, you should purchase U.S. Treasury Bills maturing in late March with the applicable portion of the January 5th distribution. Then advise us in the last week of February of the amount you wish to invest in bonds and we will let you know our thoughts.

About the middle of January (as soon as the exact amounts are figured and shares are received from the Transfer Agent after having been registered in your name) we will distribute the DRC and B-H stock applicable to your partnership interest and subsequently advise you of your tax basis and acquisition date attributable to the stock. Such shares will be "legended" as described in the enclosed letter from Monen, Seidler & Ryan. These stock certificates are valuable and should be kept in a safe place.

In past letters I had expressed the hope that BPL could supply a mechanism whereby you could, if you wished, automatically convert your DRC and B-H to cash. I have had two law firms consider extensively the status of these shares in your hands following the liquidation and the accompanying letters (which should be saved and kept with the shares) give their conclusions. As you can see, it is not an area that produces simple, clear-cut guidelines. I see no prudent way to implement the alternatives I had previously been considering. Therefore, you must follow the guidelines they set forth if you wish to dispose of your shares. As you probably realize, the restrictions on subsequent sale apply more severely to Susie and me (because of my continued "insider" position) than they probably do to you. Substantial quantities of securities often are sold via the "private sale" option described in paragraph (3) of the opinion. If the rules become clearer or more simplified in the future, I will be sure to let you know.

At the time of distribution of DRC and B-H, I will advise you of the values applied to such shares at 1969 yearend. You will receive our audit and tax letter about the end of January. It presently appears that sale of our Blue Chip shares and a substantial increase in value of DRC and B- H will bring our overall gain for the year to slightly over 6%.

My next letter will be in late December, summarizing the questions and answers regarding DRC and B-H. and also supplying a final estimate on the January 5th cash distribution.

Warren E. Buffett

WEBI glk
Enclosures:
Legal opinion. Monen, Seidler & Ryan
Concurring opinion, Munger, Tolles. Hills & Rickershauser 1968 Annual Report. Berkshire Hathaway. Inc.
1969 Semi-Annual Report. Berkshire Hathaway. Inc.
April 3. 1969 letter to Shareholders. Berkshire Hathaway. Inc. 1968 Annual Report. Diversified Retailing

Company. Inc.
Financial information regarding Associated Retail Stores. Inc. Financial information regarding Illinois National Bank & Trust Co. 1969 Best's Report. National Indemnity Company
1969 Best's Report. National Fire & Marine Insurance Company

BUFFETT PARTNERSHIP. LTD.
610 KIEWIT PLAZA
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December 26, 1969

To My Partners:

Our plans regarding the initial cash distribution have been finalized and we expect to mail to you on January 3rd a check dated January 5th, 1970 for approximately 64% of your January 1st. 1969 capital, less any distributions made to you (including monthly payments) since January 1st. 1969. If you have taken no monthly payments during 1969, there will be a small interest adjustment in your favor; if you have had loans from BPL, there will be an interest charge. I couldn't be more delighted about the action of the bond and stock markets from the standpoint of the timing of our liquidation. I believe practically all partners - whether they would have invested in bonds or stocks - will be far better off receiving the cash now than if we had liquidated at the end of last year. Those seeking income will receive about 40% more after tax on the same principal investment than they would have achieved only a year ago at what then seemed like generous yields.

Our tax picture is virtually complete and it appears that you will have ordinary income (dividends plus interest income less ordinary loss) for Federal tax purposes of about 3 –3/4% of your January 1st. 1969 capital (item 1 in enclosed letter), no significant long-term capital gain or loss, and a short-term capital loss of about 8-1/2% of your January 1st, 1969 unrealized appreciation (item 3). These estimates are just rough approximations - definitive figures will reach you in early February.

The sale of our 371,400 shares of Blue Chip Stamps was not completed in 1969. When the stock went into registration, it was selling at about $24 per share. The underwriters indicated a range where they expected to offer our shares (along with others) with heavy weight placed on a comparison with Sperry & Hutchinson. Shortly before the stock was to be offered, with the Dow-Jones Industrials much lower but S & H virtually unchanged, they indicated a price below their former range. We reluctantly agreed and felt we had a deal but, on the next business day, they stated that our agreed price was not feasible. We then withdrew and a much smaller offering was done.

I intend to hold our block of Blue Chip Stamps in BPL for a more advantageous disposal or eventual distribution to our partners. The odds are decent that we will do better in this manner -even if it takes a year or two - than if we had participated in a very large sale into a somewhat distressed market. Unless there is a material change in the market in the next few days, I plan to value our Blue Chip holdings at yearend at the price received by selling shareholders on the public offering after underwriting discount and expenses.

Various questions have been asked pursuant to the last letter:

1. If we are not getting a good return on the textile business of Berkshire Hathaway Inc., why do we continue to operate it?

Pretty much for the reasons outlined in my letter. I don't want to liquidate a business employing 1100 people when the Management has worked hard to improve their relative industry position, with reasonable results, and as long as the business does not require substantial additional capital investment. I have no desire to trade severe human dislocations for a few percentage points additional return per annum. Obviously, if we faced material compulsory additional investment or sustained operating losses, the decision might have to be different, but I don't anticipate such alternatives.

2. How large is our investment in Sun Newspapers, etc., and do we intend to expand in the newspaper, radio and TV business?

The combined investment in Sun, Blacker Printing and Gateway Underwriters is a little over $1 per share of Berkshire Hathaway, and earns something less than 10 cent per share. We have no particular plans to expand in the communication field.

3. What does Gateway Underwriters do?

Gateway Underwriters serves primarily as a General Agent for National Indemnity Company in the State of Missouri.

4. Are there good "second men" to take over from the men running the three excellent operating businesses?

In any company where the founder and chief driving force behind the enterprise is still active, it is very difficult to evaluate "second men". The only real way to see how someone is going to do when running a company is to let him run it. Some of our businesses have certainly been more "one-man shows" than the typical corporation. Subject to the foregoing caveat, I think that we do have some good "second men" coming along.

5. In what area do you plan to invest the cash in Diversified Retailing Company and do you intend to stick primarily to the retailing field?

While we prefer the retailing field, we do not preclude anything that will make sense. We have been looking without success for two years for an intelligent acquisition for DRC, so we are not about to rule out any industry, if the business looks good. Pending such time as we find one or more operating businesses to buy, the money will be invested in marketable securities.

6. Why didn't DRC payout the money it received on the sale of Hochschild, Kohn & Company?

In addition to the fact that such a payment would constitute a dividend, taxable in significant part as ordinary income, there are restrictions in the bond indenture which prevent such a pay-out without turning over control of the company to the bondholders.

7. Will distribution of the DRC stock cause the DRC debentures to be called?

After distribution of the stock, I will be the largest stockholder in DRC and, hence, the call provision will not apply.

8. How would we know if the DRC debentures were called?

All stockholders and debenture holders would find out directly from the company through regular or special reports that the company issues to its security holders. There is no intention at all of calling the debentures.

9. Why did you not register our Berkshire Hathaway and Diversified Retailing shares so that the stock, when received by the partners, would be freely marketable?

We considered this possibility but rejected it for both practical and legal considerations. I will just discuss the practicalities, since they would independently dictate the decision we made.

There is presently no existing market for Diversified Retailing, and our holdings of Berkshire Hathaway are probably four or five times the present floating supply of this stock. An attempt to quickly buy or sell a few thousand shares can easily move BH stock several points or more. We own 691,441 shares. Were we to distribute these stocks to you via a registration without an underwriting, and with the possibility that a substantial portion would be offered for sale by many sellers operating individually but virtually simultaneously, there is a real likelihood, particularly in a stock market environment such as we have seen recently, that the market for these two stocks would be little short of chaotic. It has not seemed to me that this was the kind of situation with which I should leave you, both from the standpoint of the price level which might prevail, as well as for the reason that different partners might well have to liquidate at widely varying price levels. The more sophisticated partners might have an important edge on the less sophisticated ones, and I believe many partner's might have no chance to realize the prices I anticipate using for yearend valuation. This would rightly seem most unfair to you, since I would have received some allocation of 1969 BPL profits based upon these yearend valuations. If the markets were to become distressed, I would probably come in for criticism, whether I personally bought at lower prices or, perhaps more so, if I refrained from buying.

Were we to attempt to sponsor an underwriting in connection with a registration for those partners who might wish to sell, there would be, in my opinion, the likelihood that the result would still be far less than satisfactory. We have just been around this track with our holdings of Blue Chip Stamps, where we watched the price of our stock go from 24 to 16-1/2 after announcement of the underwriting, of which we originally were to be a part. I did not want this sort of result for the partners with respect to their holdings of Berkshire and Diversified.

It is my belief that, by confining sales to private placements, those partners who wish to sell will realize more for their stock (with the sophisticated partners having no marketing edge on the less knowledgeable) than would be achieved, through an underwriting at this time. Also, the stock should be more likely to find its way into the hands of long-term investment-minded holders, which should mean less volatile markets in the future. We have had several phone calls from persons indicating that they wish to make private sales - we anticipate there will be no difficulty in effectuating such sales at prices related to our yearend valuations.

Those partners who would prefer an underwritten distribution always have the option of having a registration of their own. I will be glad to facilitate this by placing all partners in touch with each other who indicate to me their desire to sell via a registered underwriting, at their expense and through an underwriter of their choice. In this way the expense of an underwriting, which can be considerable, would be borne by the selling partners and not by the partners as a whole.

I have also had partners ask if they could participate in a registered offering in the future if I should sell shares in this manner. I think it is almost certain I will never sell stock via public offering but, should it ever happen, I will be glad to let any of you participate in any underwritten offering in which I might be involved. In all probability, if it ever did happen, your stock would already be "free", although mine would still be restricted. I cannot make the same commitment to you regarding any private sale I might make in the future, just as I can't expect you to restrict any sale options you might have in order to include me.

10. Will you let us know if you sell your holdings of BH or DRC?

You would undoubtedly know from corporate communications, reports in the press and reports to Government agencies if I disposed of my holdings. I have no intention at all of doing so in the foreseeable future - I merely make no commitment not to. However, former BPL partners will have no priority over other BH or DRC security holders in obtaining information relating to their corporate activities.

11. Should I hold my BH or DRC stock?

I can't give you the answer on this one. All I can say is that I'm going to do so and I plan to buy more. I am very happy to have a material portion of my net worth invested in these companies on a long term basis. Obviously, I think they will be worth significantly more money five or ten years hence. Compared to most stocks, I think there is a low risk of loss. I hope their price patterns follow a rather moderate range related to business results rather than behaving in a volatile manner related to speculative enthusiasm or depression. Obviously, I cannot control the latter phenomena, but there is no intent to "promote" the stocks a la much of the distasteful general financial market activity of recent years.

12. Can I give either BH or DRC shares to my wife or children?

We are advised by counsel that this is permissible but, of course the same restrictions on transfer that applied to you would apply to the donee of the gift.

13. Why are you waiting until March to give us your suggestions regarding bonds?

January and February promise to be very busy months. Many partners may want to talk to me about their questions and objectives regarding bonds. I want to have all important BPL matters out of the way before I talk with any of them on an individual basis. I make no forecasts regarding the bond market (or stock market) - it may be higher or lower in March than now. After my October letter, several partners became very eager to buy bonds immediately - to date they are much better off by waiting. The excellent quality tax-free bonds I talked about at that time with yields of 6 -1/2% can now be bought to yield about 7%.

Cordially,

Warren E. Buffett

WEB/glk

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February 25th, 1970

To My Partners:

This letter will attempt to provide a very elementary education regarding tax-exempt bonds with emphasis on the types and maturities of bonds which we expect to help partners in purchasing next month. If you expect to use our help in the purchase of bonds, it is important that you carefully read (and, if necessary , reread) this letter as it will serve as background for the specific purchases I suggest. If you disagree with me as to conclusions regarding types of bonds or maturities (and you would have been right and I would have been wrong if you had disagreed with me on the latter point either one or two years ago), you may well be correct, but we cannot be of assistance to you in the purchase of bonds outside our area. We will simply have our hands full concentrating in our recommended area, so will be unavailable to assist or advise in the purchase of convertible bonds, corporate bonds or short term issues.

I have tried to boil this letter down as much as possible. Some of it will be a little weighty - some a little over-simplified. I apologize for the shortcomings in advance. I have a feeling I am trying to put all the meat of a 100 page book in 10 pages - and have it read like the funny papers.

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I am sure you understand that our aid in the purchase of bonds will involve no future assistance regarding either these specific bonds or general investment decisions. I want to be available at this time to be of help because of the unusual amount of cash you have received in one distribution from us. I have no desire to be in the investment counseling business, directly or indirectly, and will not be available for discussion of financial matters after March 31st.

****

The mechanics of Tax-Free Bonds.

For those who wish our help, we will arrange the purchase of bonds directly from municipal bond dealers throughout the country and have them confirm sale of the bonds directly to you. The confirmation should be saved as a basic document for tax purposes. You should not send a check to the bond dealer since he will deliver the bonds to your bank, along with a draft which the bank will pay by charging your account with them. In the case of bonds purchased in the secondary market (issues already outstanding), this settlement date will usually be about a week after confirmation date whereas, on new issues, the settlement date may be as much as a month later. The settlement date is shown plainly on the confirmation ticket (in the case of new issues this will be the second and final ticket rather than the preliminary "when issued" ticket), and you should have the funds at your bank ready to pay for the bonds on the settlement date. If you presently own Treasury Bills, they can be sold on a couple of days notice by your bank upon your instructions, so you should experience no problems in having the money available on time. Interest begins to accrue to you on the settlement date, even if the bond dealer is late in getting them delivered to your bank.

Bonds will be delivered in negotiable form (so-called "bearer" form which makes them like currency) with coupons attached. Usually the bonds are in $5,000 denominations and frequently they can be exchanged for registered bonds (sometimes at considerable expense and sometimes free-it depends upon the terms). Bonds in registered form are nonnegotiable without assignment by you, since you are the registered owner on the Transfer Agent's books. Bonds trade almost exclusively on a bearer basis and it is virtually impossible to sell registered bonds without converting them back into bearer form. Thus, unless you are going to own great physical quantities of bonds. I recommend keeping bonds in bearer form. This means keeping them in a very safe place and clipping the coupons every six months. Such coupons, when clipped, can be deposited in your bank account just like checks. If you have $250,000 in bonds, this probably means about fifty separate pieces of paper ($5,000 denominations) and perhaps six or eight trips a year to the safe deposit section to cut and deposit coupons.

It is also possible to open a custody account with a bank where, for a fairly nominal cost, they will keep the bonds, collect the interest and preserve your records for you. For example, a bank will probably perform the custodial service for you for about $200 a year on a $250,000 portfolio. If you are interested in a custodial account, you should talk to a Trust Officer at your commercial bank as to the nature of their services and cost. Otherwise, you should have a safe deposit box.

<u>Taxation</u>

The interest received upon the deposit of coupons from tax-free bonds is, of course, free from Federal Income Taxes. This means if you are at a 30% top Federal Income Tax bracket, a 6% return from tax-free bonds is equivalent to about 8-1/2% from taxable bonds. Thus, for most of our partners, excluding minors or some retired people, tax-free bonds will be more attractive than taxable bonds. For people with little or no income from wages or dividends, but with substantial capital, it is possible that a combination of taxable bonds (to bring taxable income up to about the 25% or 30% bracket) plus tax-free bonds will bring the highest total after-tax income. Where appropriate, we will work with you to achieve such a balance.

The situation in respect to State Income Taxes is more complicated. In Nebraska. where the State Income Tax is computed as a percentage of the Federal Income Tax, the effect is that there is no state tax on interest from tax-free bonds. My understanding of both the New York and California law is that tax-free bonds of entities within the home state are not subject to State Income Tax, but tax-free bonds from other states are subject to the local State Income Tax. I also believe that the New York City Income Tax exempts tax-free bonds of entities based within the State of New York, but taxes those from other states. I am no expert on state income taxes and make no attempt to post myself on changes taking place within the various states or cities. Therefore, I defer to your local tax advisor, but simply mention these few general impressions so that you will be alert to the existence of a potential problem. In Nebraska there is no need to have any local considerations enter into the after-tax calculation. Where out-of-state issues are subject to local taxation, the effective cost of your State or Municipal Income Tax is reduced by the benefit received from deducting it on your Federal Income Tax return. This, of course, varies with the individual. Additionally, in some states there are various taxes on intangible property which may apply to all tax-free bonds or just those of out-of-state entities. There are none of these in Nebraska, but I cannot advise on the other states.

When bonds are bought at a discount from par and later are sold or mature (come due and get paid), the difference between the proceeds and cost is subject to capital gain or loss treatment. (There are minor exceptions to this statement as, unfortunately, there are to most general statements on investments and taxes but they will be pointed out to you should they affect any securities we recommend). This reduces the net after-tax yield by a factor involving the general rate of future capital gains taxes and the specific future tax position of the individual. Later on, we will discuss the impact of such capital gains taxes in calculating the relative attractiveness of discount bonds versus "full coupon" bonds.

Finally, one most important point. Although the law is not completely clear, you should probably not contemplate owning tax-free bonds if you have, or expect to have, general purpose bank or other indebtedness.

The law excludes the deductibility of interest on loans incurred or continued to purchase or carry tax-free bonds, and the interpretation of this statute will probably tend to be broadened as the years pass. For example, my impression is that you have no problem if you have a mortgage against real property (unless the debt was incurred in order to acquire municipal bonds) in deducting the mortgage interest on your Federal Tax return, even though you own tax-free bonds at the same time. However, I believe that if you have a general bank loan, even though the proceeds were directly used to purchase stocks, a handball court, etc. and the tax-free bonds are not used for security for the loan, you are asking for trouble if you deduct the interest and, at the same time, are the owner of tax-free bonds. Therefore, I would pay off bank loans before owning tax-free bonds, but I leave detailed examination of this question to you and your tax advisor. I merely mention it to make you aware of the potential problem.

Marketability

Tax-free bonds are materially different from common stocks or corporate bonds in that there are literally hundreds of thousands of issues, with the great majority having very few holders. This substantially inhibits the development of close, active markets. Whenever the City of New York or Philadelphia wants to raise money it sells perhaps twenty, thirty or forty non-identical securities, since it will offer an issue with that many different maturities. A 6% bond of New York coming due in 1980 is a different animal from a 6% bond of New York coming due in 1981. One cannot be exchanged for the other, and a seller has to find a buyer for the specific item he holds. When you consider that New York may offer bonds several times a year, it is easy to see why just this one city may have somewhere in the neighborhood of 1,000 issues outstanding. Grand Island, Nebraska may have 75 issues outstanding. The average amount of each issue might be $100,000 and the average number of holders may be six or eight per issue. Thus, it is absolutely impossible to have quoted markets at all times for all issues and spreads between bids and offers may be very wide. You can't set forth in the morning to buy a specific Grand Island issue of your choosing. It may not be offered at any price, anywhere, and if you do find one seller, there is no reason why he has to be realistic compared to other offerings of similar quality. On the other hand, there are single issues such as those of the Ohio Turnpike, Illinois Turnpike, etc. that amount to $200 million or more and have thousands of bondholders owning a single entirely homogeneous and interchangeable issue. Obviously, here you get a high degree of marketability.

My impression is that marketability is generally a function of the following three items, in descending order of importance: (1) the size of the particular issue; (2) the size of the issuer (a $100,000 issue of the State of Ohio will be more marketable than a $100,000 issue of Podunk, Ohio); and (3) the quality of the issuer. By far the most sales effort goes into the selling of new issues of bonds. An average of over $200 million per week of new issues comes up for sale, and the machinery of bond distribution is geared to get them sold, large or small. In my opinion, there is frequently insufficient differential in yield at time of issue for the marketability differences that will exist once the initial sales push is terminated. We have frequently run into markets in bonds where the spread between bid and asked prices may get to 15%. There is no need to buy bonds with the potential for such grotesque markets (although the profit spread to the dealer who originally offers them is frequently wider than on more marketable bonds) and we will not be buying them for you. The bonds we expect to buy will usually tend to have spreads (reflecting the difference between what you would pay net for such bonds on purchase and receive net on sale at the same point in time) of from 2% to 5%. Such a spread would be devastating if you attempted to trade in such bonds, but I don't believe it should be a deterrent for a long-term investor. The real necessity is to stay away from bonds of very limited marketability - which frequently are the type local bond dealers have the greatest monetary incentive to push.

Specific Areas of Purchase

We will probably concentrate our purchases in the following general areas:

(1) Large revenue-producing public entities such as toll roads, electric power districts, water districts, etc.

Many of these issues possess high marketability, are subject to quantitative analysis, and sometimes have favorable sinking fund or other factors which tend not to receive full valuation in the market place.

(2) Industrial Development Authority bonds which arise when a public entity holds title to property leased to a private corporation. For example, Lorain, Ohio holds title to an $80 million project for U.S. Steel Corp. The Development Authority Board issued bonds to pay for the project and has executed a net and absolute lease with U.S. Steel to cover the bond payments. The credit of the city or state is not behind the bonds and they are only as good as the company that is on the lease. Many top-grade corporations stand behind an aggregate of several billion dollars of these obligations, although new ones are being issued only in small amounts ($5 million per project or less) because of changes in the tax laws. For a period of time there was a very substantial prejudice against such issues, causing them to sell at yields considerably higher than those commensurate with their inherent credit standing. This prejudice has tended to diminish, reducing the premium yields available, but I still consider it a most attractive field. Our insurance company owns a majority of its bonds in this category.

(3) Public Housing Authority Issues for those of you who wish the very highest grade of tax-free bonds. In effect, these bonds bear the guarantee of the U.S. Government, so they are all rated AAA. In states where local taxes put a premium on buying in-state issues, and I can’t fill your needs from (1) and (2) , my tendency would be to put you into Housing Authority issues rather than try to select from among credits that I don't understand. If you direct me to buy obligations of your home state, you should expect substantial quantities of Housing Authority issues. There is no need to diversify among such issues, as they all represent the top credit available.

(4) State obligations of a direct or indirect nature.

You will notice I am not buying issues of large cities. I don't have the faintest idea how to analyze a New York City, Chicago, Philadelphia, etc. (a friend mentioned the other day when Newark was trying to sell bonds at a very fancy rate that the Mafia was getting very upset because Newark was giving them a bad name). Your analysis of a New York City - and I admit it is hard to imagine them not paying their bills for any extended period of time - would be as good as mine. My approach to bonds is pretty much like my approach to stocks. If I can't understand something, I tend to forget it. Passing an opportunity which I don't understand - even if someone else is perceptive enough to analyze it and get paid well for doing it - doesn't bother me. All I want to be sure of is that I get paid well for the things I do feel capable of handling - and that I am right when I make affirmative decisions.

We will probably tend to purchase somewhere between five and ten issues for most of you. However, if you wish to limit me to your home state, it may be fewer issues - and perhaps those will only be Housing Authorities. We will try not to buy in smaller than $25,000 pieces and will prefer larger amounts where appropriate. Smaller lots of bonds are usually penalized upon resale, sometimes substantially. The bond salesman doesn't usually explain this to you when you buy the $10,000 of bonds from him, but it gets explained when you later try to sell the $10,000 to him. We may make exceptions where we are buying secondary market issues in smaller pieces - but only if we are getting an especially good price on the buy side because of the small size of the offering.

<u>Callable Bonds</u>

We will not buy bonds where the issuer of the bonds has a right to call (retire) the bonds on a basis which substantially loads the contract in his favor. It is amazing to me to see people buy bonds which are due in forty years, but where the issuer has the right to call the bonds at a tiny premium in five or ten years. Such a contract essentially means that you have made a forty year deal if it is advantageous to the issuer (and disadvantageous to you) and a five year deal if the initial contract turns out to be advantageous to you (and disadvantageous to the issuer). Such contracts are really outrageous and exist because bond investors can't think through the implications of such a contract form and bond dealers don't insist on better terms for their customers. One extremely interesting fact is that bonds with very unattractive call features sell at virtually the same yield as otherwise identical bonds which are noncallable.

It should be pointed out that most Nebraska bonds carry highly unfair call provisions. Despite this severe contractual disadvantage, they do not offer higher yields than bonds with more equitable terms.

One way to avoid this problem is to buy bonds which are totally noncallable. Another way is to buy discount bonds where the right of the issuer to call the bond is at a price so far above your cost as to render the possible call inconsequential. If you buy a bond at 60 which is callable at 103, the effective cost to you of granting the issuer the right to prematurely terminate the contract (which is a right you never have) is insignificant. But to buy a bond of the Los Angeles Department of Water and Power at 100 to come due at 100 in 1999 or to come due at
104 in 1974, depending on which is to the advantage of the issuer and to your disadvantage, is the height of foolishness when comparable yields are available on similar credits without such an unfair contract. Nevertheless, just such a bond was issued in October, 1969 and similar bonds continue to be issued every day. I only write at such length about an obvious point, since it is apparent from the continual sale of such bonds that many investors haven't the faintest notion how this loads the dice against them and many bond salesmen aren't about to tell them.

Maturity and the Mathematics of Bonds

Many people, in buying bonds, select maturities based on how long they think they are going to want to hold bonds, how long they are going to live, etc. While this is not a silly approach, it is not necessarily the most logical. The primary determinants in selection of maturity should probably be (1) the shape of the yield curve; (2) your expectations regarding future levels of interest rates and (3) the degree of quotational fluctuation you are willing to endure or hope to possibly profit from. Of course, (2) is the most important but by far the most difficult upon which to comment intelligently.

Let's tackle the yield curve first. When other aspects of quality are identical, there will be a difference in interest rates paid based upon the length of the bond being offered. For example, a top grade bond being offered now might have a yield of 4.75% if it came due in six or nine months, 5.00% in two years, 5.25% in five years, 5.50% in ten years and 6.25% in twenty years. When long rates are substantially higher than short rates, the curve is said to be strongly positive. In the U. S. Government bond market, rates recently have tended to produce a negative yield curve; that is, a long term Government bond over the last year or so has consistently yielded less than a short term one. Sometimes the yield curve has been very flat, and sometimes it is positive out to a given point, such as ten years, and then flattens out. What you should understand is that it varies, often very substantially, and that on an historical basis the present slope tends to be in the high positive range. This doesn't mean that long bonds are going to be worth more but it does mean that you are being paid more to extend maturity than in many periods. If yields remained constant for several years, you would do better with longer bonds than shorter bonds, regardless of how long you intended to hold them.

The second factor in determining maturity selection is expectations regarding future rate levels. Anyone who has done much predicting in this field has tended to look very foolish very fast. I did not regard rates as unattractive one year ago, and I was proved very wrong almost immediately. I believe present rates are not unattractive and I may look foolish again. Nevertheless, a decision has to be made and you can make just as great a mistake if you buy short term securities now and rates available on reinvestment in a few years are much lower.

The final factor involves your tolerance for quotational fluctuation. This involves the mathematics of bond investment and may be a little difficult for you to understand. Nevertheless, it is important that you get a general grasp of the principles. Let's assume for the moment a perfectly flat yield curve and a non-callable bond. Further assume present rates are 5% and that you buy two bonds, one due in two years and one due in twenty years. Now assume one year later that yields on new issues have gone to 3% and that you wish to sell your bonds. Forgetting about market spreads, commissions, etc. , you will receive $1,019.60 for the original two year $1,000 bond (now with one year to run) and $1,288.10 for the nineteen year bond (originally twenty years). At these prices, a purchaser will get exactly 3% on his money after amortizing the premium he has paid and cashing the stream of 5% coupons attached to each bond. It is a matter of indifference to him whether to buy your nineteen year 5% bond at $1,288.10 or a new 3% bond (which we have assumed is the rate current - one year later) at $1,000.00. On the other hand, let's assume rates went to 7%. Again we will ignore commissions, capital gains taxes on the discount, etc. Now the buyer will only pay $981.00 for the bond with one year remaining until maturity and $791.60 for the bond with nineteen years left. Since he can get 7% on new issues, he is only willing to buy your bond at a discount sufficient so that accrual of this discount will give him the same economic benefits from your 5% coupon that a 7% coupon at $1,000.00 would give him.

The principle is simple. The wider the swings in interest rates and the longer the bond, the more the value of a bond can go up or down on an interim basis before maturity. It should be pointed out in the first example where rates went to 3%, our long term bond would only have appreciated to about $1,070.00 if it had been callable in five years at par, although it would have gone down just as much if 7% rates had occurred. This just illustrates the inherent unfairness of call provisions.

For over two decades, interest rates on tax-free bonds have almost continuously gone higher and buyers of long term bonds have continuously suffered. This does not mean it is bad now to buy long term bonds - it simply means that the illustration in the above paragraph has worked in only one direction for a long period of time and people are much more conscious of the downside risks from higher rates than the upside potential from lower ones.

If it is a 50-50 chance as to the future general level of interest rates and the yield curve is substantially positive, then the odds are better in buying long term non-callable bonds than shorter term ones. This reflects my current conclusion and, therefore, I intend to buy bonds within the ten to twenty-five year range. If you have any preferences within that range, we will try to select bonds reflecting such preferences, but if you are interested in shorter term bonds, we will not be able to help you as we are not searching out bonds in this area.

Before you decide to buy a twenty year bond, go back and read the paragraph showing how prices change based upon changes in interest rates. Of course, if you hold the bond straight through, you are going to get the contracted rate of interest, but if you sell earlier, you are going to be subject to the mathematical forces described in that paragraph, for better or for worse. Bond prices also change because of changes in quality over the years but, in the tax-free area, this has tended to be - and probably will continue to be - a relatively minor factor compared to the impact of changes in the general structure of interest rates.

Discount Versus Full Coupon Bonds

You will have noticed in the above discussion that if you now wanted to buy a 7% return on a nineteen year bond, you had a choice between buying a new nineteen year bond with a 7% coupon rate or buying a bond with a 5% coupon at $791.60, which would pay you $1,000.00 in nineteen years. Either purchase would have yielded exactly 7% compounded semi-annually to you. Mathematically, they are the same. In the case of tax-free bonds the equation is complicated, however, by the fact that the $70.00 coupon is entirely tax-free to you, whereas the bond purchased at a discount gives you tax-free income of $50.00 per year but a capital gain at the end of the nineteenth year of $208.40. Under the present tax law, you would owe anything from a nominal tax, if the gain from realization of the discount was your only taxable income in the nineteenth year, up to a tax of over $70.00 if it came on top of very large amounts of capital gain at that time (the new tax law provides for capital gain rates of 35%, and even slightly higher on an indirect basis in 1972 and thereafter for those realizing very large gains.) In addition to this, you might have some state taxes to pay on the capital gain.

Obviously, under these circumstances you are not going to pay the $791.60 for the 5% coupon and feel you are equally as well off as with the 7% coupon at $1,000.00. Neither is anyone else. Therefore, identical quality securities with identical maturities sell at considerably higher gross yields when they have low coupons and are priced at discounts than if they bear current high coupons.

Interestingly enough, for most taxpayers, such higher gross yields over-compensate for the probable tax to be paid. This is due to several factors. First, no one knows what the tax law will be when the bonds mature and it is both natural and probably correct to assume the tax rate will be stiffer at that time than now. Second, even though a 5% coupon on a $1,000.00 bond purchased at $791.60 due in nineteen years is the equivalent of a 7% coupon on a $1,000.00 bond purchased at par with the same maturity, people prefer to get the higher current return in their pocket. The owner of the 5% coupon bond is only getting around 6.3% current yield on his $791.60 with the balance necessary to get him up to 7% coming from the extra $208.40 he picks up at the end. Finally, the most important factor affecting prices currently on discount bonds (and which will keep affecting them) is that banks have been taken out of the market as buyers of discount tax-free bonds by changes brought about in bank tax treatment through the 1969 Tax Reform Act. Banks have historically been the largest purchasers and owners of tax-free bonds and anything that precludes them from one segment of the market has dramatic effects on the supply-demand situation in that segment. This may tend to give some edge to individuals in the discount tax-free market, particularly those who are not likely to be in a high tax bracket when the bonds mature or are sold.

If I can get a significantly higher effective after-tax yield (allowing for sensible estimates of your particular future tax rate possibilities), I intend to purchase discount bonds for you. I know some partners prefer full coupon bonds, even though their effective yield is less, since they prefer to maximize the current cash yield and if they will so advise me, we will stick to full coupon issues (or very close thereto) in their cases.

<u>Procedure</u>

I intend to be in the office solidly through March (including every Saturday except March 7th) and will be glad to see any partner or talk with him by phone. To aid in scheduling, please make an appointment with Gladys (or me). The only request I make is that you absorb as much as possible of this letter before we talk. As you can see, it would be an enormous problem if I had to explain each item to all of you.

If you decide you want us to help you in buying bonds, you should let us know:

(1) Whether you want to restrict purchases to your home state for local tax reasons;

(2) Whether you want to restrict us to full coupon issues or let us use our judgment as to where you get the best value;

(3) Your preference as to maturity in the ten to twenty-five year range or if you prefer to let us use our judgment in that area;

(4) How much you want to invest - we may end up several per cent short of the figure you name, but we will never go over;

(5) On what bank the bonds should be drafted.

We will advise you by phone or letter as we buy bonds. Bill and John will be doing much of the mechanical work. Needless to say, none of us will have any financial interest in any transaction. Should you have any questions regarding the mechanics, please direct them to John or Bill as I will probably be swamped and they will be more familiar with specific transactions. After March 31st, I don't expect to be around the office for several months. Therefore, if you want to talk things over, come in by then. The completion of all purchases may go into April, but Bill will be taking care of this and the mechanics will all be set up.

You should realize that because of the enormous diversity of issues mentioned earlier, it is impossible to say just what will be bought. Sometimes the tax-free bond market has more similarities to real estate than to stocks. There are hundreds of thousands of items of varying comparability, some with no sellers, some with reluctant sellers and some with eager sellers. Which may be the best buy depends on the quality of what is being offered, how well it fits your needs and the eagerness of the seller. The standard of comparison is always new issues where an average of several hundred million dollars worth have to be sold each week - however, specific secondary market opportunities (issues already outstanding) may be more attractive than new issues and we can only find out how attractive they are when we are ready to make bids.

Although markets can change, it looks as if we will have no difficulty in getting in the area of 6-1/2% after tax (except from Housing Authority issues) on bonds in the twenty-year maturity range.

Cordially,

Warren E. Buffett

WEBI glk