Berkshire Hathaway Letter 1974

To the Stockholders of Berkshire Hathaway Inc.:

Operating results for 1974 overall were unsatisfactory due to the poor performance of our insurance business. In last year's annual report some decline in profitability was predicted but the extent of this decline, which accelerated during the year, was a surprise. Operating earnings for 1974 were $8,383,576, or $8.56 per share, for a return on beginning shareholders' equity of 10.3%. This is the lowest return on equity realized since 1970. Our textile division and our bank both performed very well, turning in improved results against the already good figures of 1973. However, insurance underwriting, which has been mentioned in the last several annual reports as running at levels of unsustainable profitability, turned dramatically worse as the year progressed.

The outlook for 1975 is not encouraging. We undoubtedly will have sharply negative comparisons in our textile operation and probably a moderate decline in banking earnings. Insurance underwriting is a large question mark at this time—it certainly won't be a satisfactory year in this area, and could be an extremely poor one. Prospects are reasonably good for an improvement in both insurance investment income and our equity in earnings of Blue Chip Stamps. During this period we plan to continue to build financial strength and liquidity, preparing for the time when insurance rates become adequate and we can once again aggressively pursue opportunities for growth in this area.

Textile Operations

During the first nine months of 1974 textile demand was exceptionally strong, resulting in very firm prices. However, in the fourth quarter significant weaknesses began to appear, which have continued into 1975.

We currently are operating at about one-third of capacity. Obviously, at such levels operating losses must result. As shipments have fallen, we continuously have adjusted our level of operations downward so as to avoid building inventory.

Our products are largely in the curtain goods area. During a period of consumer uncertainty, curtains may well be high on the list of deferrable purchases. Very low levels of housing starts also serve to dampen demand. In addition, retailers have been pressing to cut inventories generally, and we probably are feeling some effect from these efforts. These negative trends should reverse in due course, and we are attempting to minimize losses until that time comes.

Insurance Underwriting

In the last few years we consistently have commented on the unusual profitability in insurance underwriting. This seemed certain eventually to attract unintelligent competition with consequent inadequate rates. It also has been apparent that many insurance organizations, major as well as minor, have been guilty of significant underreserving of losses, which inevitably produces faulty information as to the true cost of the product being sold. In 1974, these factors, along with a high rate of inflation, combined to produce a rapid erosion in underwriting results.

The costs of the product we deliver (auto repair, medical payments, compensation benefits, etc.) are increasing at a rate we estimate to be in the area of 1% per month. Of course, this increase doesn't proceed in an even flow but, inexorably, inflation grinds very heavily at the repair services—to humans and to property—that we provide. However, rates virtually have been unchanged in the property and casualty field for the last few years. With costs moving forward rapidly and prices remaining unchanged, it was not hard to predict what would happen to profit margins.

Best's, the authoritative voice of the insurance industry, estimates that in 1974 all auto insurance premiums in the United States increased only about 2%. Such a growth in the pool of dollars available to pay insured losses and expenses was woefully inadequate. Obviously, medical costs applicable to people injured during the year, jury awards for pain and suffering, and body shop charges for repairing damaged cars increased at a dramatically greater rate during the year. Since premiums represent the sales dollar and the latter items represent the cost of goods sold, profit margins turned sharply negative.

As this report is being written, such deterioration continues. Loss reserves for many giant companies still appear to be understated by significant amounts, which means that these competitors continue to underestimate their true costs. Not only must rates be increased sufficiently to match the month-by-month increase in cost levels, but the existed expense-revenue gap must be overcome. At this time it appears that insurors must experience even more devastating underwriting results before they take appropriate pricing action.

All major areas of insurance operations, except for the "home state" companies, experienced significantly poorer results for the year.

The direct business of National Indemnity Company, our largest area of insurance activity, produced an underwriting loss of approximately 4% after several years of high profitability. Volume increased somewhat, but we are not encouraging such increases until rates are more adequate. At some point in the cycle, after major insurance companies have had their fill of red ink, history indicates that we will experience an inflow of business at compensatory rates. This operation, headed by Phil Liesche, a most able underwriter, is staffed by highly profit-oriented people and we believe it will provide excellent earnings in most future years, as it has in the past.

Intense competition in the reinsurance business has produced major losses for practically every company operating in the area. We have been no exception. Our underwriting loss was something over 12%—a horrendous figure, but probably little different from the average of the industry. What is even more frightening is that, while about the usual number of insurance catastrophes occurred during 1974, there really was no "super disaster" which might have accounted for the poor figures of the industry. Rather, a condition of inadequate rates prevails, particularly in the casualty area where we have significant exposure. Our reinsurance department is run by George Young, an exceptionally competent and hardworking manager. He has cancelled a great many contracts where prices are totally inadequate, and is making no attempt to increase volume except in areas where premiums are commensurate with risk. Based upon present rate levels, it seems highly unlikely that the reinsurance industry generally, or we, specifically, will have a profitable year in 1975.

Our “home state” companies, under the leadership of John Ringwalt, made good progress in 1974. We appear to be developing a sound agency group, capable of producing business with acceptable loss ratios. Our expense ratios still are much too high, but will come down as the operation develops into units of economic size. The Texas problem which was commented upon in last year’s report seems to be improving. We consider the “home state” operation one of our most promising areas for the future.

Our efforts to expand Home and Automobile Insurance Company into Florida proved disastrous. The underwriting loss from operations in that market will come to over $2 million, a very large portion of which was realized in 1974. We made the decision to drop out of the Florida market in the middle of 1974, but losses in substantial amounts have continued since that time because of the term nature of insurance contracts, as well as adverse development of outstanding claims. We can’t blame external insurance industry conditions for this mistake. In retrospect, it is apparent that our management simply did not have the underwriting information and the pricing knowledge necessary to be operating in the area. In Cook County, where Home and Auto’s volume traditionally has been concentrated, evidence also became quite clear during 1974 that rates were inadequate. Therefore, rates were increased during the middle of the year but competition did not follow; consequently, our volume has dropped significantly in this area as competitors take business from us at prices that we regard as totally unrealistic.

While the tone of this section is pessimistic as to 1974 and 1975, we consider the insurance business to be inherently attractive. Our overall return on capital employed in this area—even including the poor results of 1974—remains high. We have made every effort to be realistic in the calculation of loss and administrative expense. Because of accruals, this had a double effect at both the bank and corporate level in 1974.

Under present money market conditions, we expect bank earnings to be down somewhat in 1975 although we believe they still are likely to compare favorably with those of practically any banking institution in the country.

Blue Chip Stamps

During 1974 we increased our holdings of Blue Chip Stamps to approximately 25.5% of the outstanding shares of that company. Overall, we are quite happy about the results of Blue Chip and its prospects for the future. Stamp sales continue at a greatly reduced level, but the Blue Chip management has done an excellent job of adjusting operating costs. The See’s Candy Shops, Inc. subsidiary had an outstanding year, and has excellent prospects for the future.

Your Chairman is on the Board of Directors of Blue Chip Stamps, as well as Wesco Financial Corporation, a 64% owned subsidiary, and is Chairman of the Board of See’s Candy Shops, Inc. We expect Blue Chip Stamps to be a source of continued substantial earning power for Berkshire Hathaway Inc.

The annual report of Blue Chip Stamps, which will contain financial statements for the year ended March 1, 1975 audited by Price, Waterhouse and Company, will be available in May. Any shareholder of Berkshire Hathaway Inc. who desires an annual report of Blue Chip Stamps may obtain it at any time by writing Mr. Robert H. Bird, Secretary, Blue Chip Stamps, 5801 South Eastern Avenue, Los Angeles, California 90040.

Merger with Diversified Retailing Company, Inc.

As you previously have been informed, the proposed merger with Diversified Retailing Company, Inc. was terminated by the respective Boards of Directors on January 28, 1975. We continue to view such a merger as eventually desirable, and hope to reopen the subject at some future time.

Warren E. Buffett
Chairman of the Board
March 31, 1975