WIT AND WISDOM FROM WARREN BUFFETT

When investing, we view ourselves as business analysts-not as market analysts, not as macroeconomic analysts, and not even as security analysts.

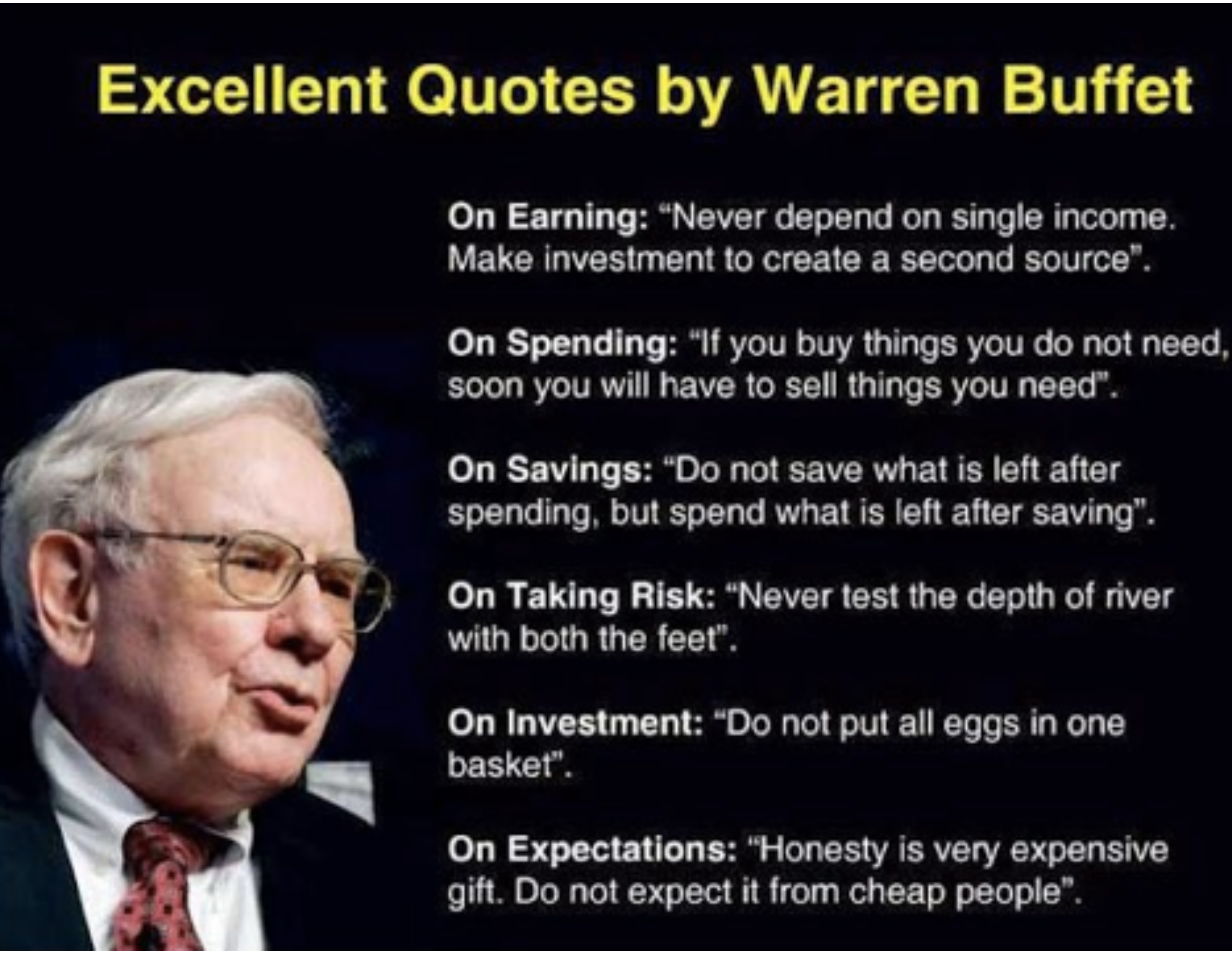
of daily quotations on World Book or Fechheimer. Eventually, our economic fate will be determined by the economic fate of the business we own, whether our ownership is partial or total.

business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his.

Even though the business that the two of you own may have economic characteristics that are stable, Mr. Market's quotations will be anything but. For, sad to say, the poor fellow has incurable emotional problems. At times he feels euphoric and can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains. At other times he is depressed and can see nothing but trouble ahead for both the business and the world. On these occasions he will name a very low price, since he is terrified that you will unload your interest on him.

at your option. Under these conditions, the more manic-depressive his behavior, the better for you.

Identical reasoning guides our thinking about Berkshire's investments. We will be buying businesses-or small parts of businesses, called stocks-year in, year out as long as I live (and longer, if Berkshire's directors attend the seances I have scheduled). Given these intentions, declining prices for businesses benefit us, and rising prices hurt us.


Excellent Quotes by Warren Buffet
On Earning: "Never depend on single income. Make investment to create a second source".
On Spending: "If you buy things you do not need, soon you will have to sell things you need".
On Savings: "Do not save what is left after spending, but spend what is left after saving".
On Taking Risk: "Never test the depth of river with both the feet".
On Investment: "Do not put all eggs in one basket".
On Expectations: "Honesty is very expensive gift. Do not expect it from cheap people".

everything will turn into pumpkins and mice: Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence. Indeed, if you aren't certain that you understand and can value your business far better than Mr. Market you don't belong in the game. As they say in poker, "If you've been in the game 30 minutes and you don't know who the patsy is, *you're* the patsy."

investor will succeed by coupling good business judgment with an ability to insulate his thoughts and behavior from the super-contagious emotions that swirl about the marketplace. In my own efforts to stay insulated, I have found it highly useful to keep Ben's Mr. Market concept firmly in mind.

equities tell us by their operating results-not by their daily, or even yearly, price quotations-whether our investments are successful. The market may ignore business success for a while, but eventually will confirm it. As Ben said: "In the short run, the market is a voting machine but in the long run it is a weighing machine." The speed at which a business's success is recognized, sic value is increasing at a satisfactory rate. In fact, delayed recognition can be an advantage: It may give us the chance to buy more of a good thing at a bargain price.

such a case, we will sell our holdings. Sometimes, also, we will sell a security that is fairly valued or even undervalued because we require funds for a still more undervalued investment or one we believe we understand better.

We need to emphasize, however, that we do not sell holdings just because they have appreciated or because we have held them for a long time. (Of Wall Street maxims the most foolish may be "You can't go broke taking a profit.") We are quite content to hold any security indefinitely, so long as the prospective return on equity capital of the underlying business is satisfactory, management is competent and honest, and the market does not overvalue the business.

However, our insurance companies own three marketable common stocks that we would not sell even though they became far overpriced in the market. In effect, we view these investments

service to us and other followers of Graham. In any sort of a contest-financial, mental, or physical-it's an enormous advantage to have opponents who have been taught that it's useless to even try.

profits of 20% a year or, for that matter, profits of any kind. As noted, the market is reasonably efficient much of the time: For

are just the opposite of those who hurry to sell and book profits when companies perform well but who tenaciously hang on to businesses that disappoint. Peter Lynch aptly likens such behavior to cutting the flowers and watering the weeds.

Charlie and I decided long ago that in an investment lifetime it's too hard to make hundreds of smart decisions. That judgment became ever more compelling as Berkshire's capital mushroomed and the universe of investments that could significantly affect our results shrank dramatically. Therefore, we adopted a strategy that required our being smart-and not too smart at that-only a very few times. Indeed, we'll now settle for one good idea a year.

vestors. We disagree. We believe that a policy of portfolio concentration may well *decrease* risk if it raises, as it should, both the intensity with which an investor thinks about a business and the comfort-level he must feel with its economic characteristics before buying into it. In stating this opinion, we define risk, using dictionary terms, as "the possibility of loss or injury."

and capital-allocation theories around this calculation. In their hunger for a single statistic to measure risk, however, they forget a fundamental principle: It is better to be approximately right than precisely wrong.

In fact, the true investor *welcomes* volatility. Ben Graham ex-

available to the investor. That's true because a wildly fluctuating market means that irrationally low prices will periodically be attached to solid businesses. It is impossible to see how the availability of such prices can be thought of as increasing the hazards for an investor who is totally free to either ignore the market or exploit its folly.

understanding of the company's business. After we buy a stock, consequently, we would not be disturbed if markets closed for a year or two. We don't need a daily quote on our 100% position in See's or H.H. Brown to validate our well-being. Why, then, should we need a quote on our 7% interest in Coke?

In our opinion, the real risk an investor must assess is whether his aggregate after-tax receipts from an investment (including those he receives on sale) will, over his prospective holding period, give him at least as much purchasing power as he had to begin with, plus a modest rate of interest on that initial stake. Though

this risk cannot be calculated with engineering precision, it can in some cases be judged with a degree of accuracy that is useful. The without any such means of protection. As Peter Lynch says, stocks of companies selling commodity-like products should come with a warning label: "Competition may prove hazardous to human wealth."

The theoretician bred on beta has no mechanism for differentiating the risk inherent in, say, a single-product toy company selling pet rocks or hula hoops from that of another toy company whose sole product is Monopoly or Barbie. But it's quite possible for ordinary investors to make such distinctions if they have a reasonable understanding of consumer behavior and the factors that create long-term competitive strength or weakness. Obviously,

block. For example, a business that must deal with fast-moving technology is not going to lend itself to reliable evaluations of its long-term economics. Did we foresee thirty years ago what would transpire in the television-manufacturing or computer industries? Of course not. (Nor did most of the investors and corporate managers who enthusiastically entered those industries.) Why, then, should Charlie and I now think we can predict the future of other rapidly-evolving businesses? We'll stick instead with the easy cases. Why search for a needle buried in a haystack when one is sitting in plain sight?

Another situation requiring wide diversification occurs when an investor who does not understand the economics of specific businesses nevertheless believes it in his interest to be a long-term owner of American industry. That investor should both own a large number of equities and space out his purchases. By periodically investing in an index fund, for example, the know-nothing investor can actually out-perform most investment professionals. Paradoxically, when "dumb" money acknowledges its limitations, it ceases to be dumb.

On the other hand, if you are a know-something investor, able to understand business economics and to find five to ten sensibly-priced companies that possess important long-term competitive advantages, conventional diversification makes no sense for you. It is apt simply to hurt your results and increase your risk. I cannot understand why an investor of that sort elects to put money into a business that is his 20th favorite rather than simply adding that money to his top choices-the businesses he understands best and that present the least risk, along with the greatest profit potential.

We have "professional" investors, those who manage many billions, to thank for most of this turmoil. Instead of focusing on what businesses will do in the years ahead, many prestigious money managers now focus on what they expect other money managers to do in the days ahead. For them, stocks are merely tokens in a game, like the thimble and flatiron in Monopoly.

he sticks to his investment knitting. Volatility caused by money managers who speculate irrationally with huge sums will offer the true investor more chances to make intelligent investment moves. He can be hurt by such volatility only if he is forced, by either financial or psychological pressures, to sell at untoward times.

The most common cause of low prices is pessimism-sometimes pervasive, sometimes specific to a company or industry. We *want* to do business in such an environment, not because we like pessimism but because we like the prices it produces. It's optimism that is the enemy of the rational buyer.

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Investors who expect to be ongoing buyers of investments throughout their lifetimes should adopt a similar attitude toward market fluctuations; instead many illogically become euphoric when stock prices rise and unhappy when they fall. They show no such confusion in their reaction to food prices: Knowing they are forever going to be buyers of food, they welcome falling prices and deplore price increases. (It's the seller of food who doesn't like

(It must be noted that your Chairman, always a quick study, required only 20 years to recognize how important it was to buy good businesses. In the interim, I searched for "bargains"-and had the misfortune to find some. My punishment was an education in the economics of short-line farm implement manufacturers, third-place department stores, and New England textile manufacturers.)

Growth benefits investors only when the business in point can invest at incremental returns that are enticing-in other words, only when each dollar used to finance the growth creates over a dollar of long-term market value. **In** the case of a low-return business requiring incremental funds, growth hurts the investor.

Inactivity strikes us as intelligent behavior. Neither we nor most business managers would dream of feverishly trading highly-profitable subsidiaries because a small move in the Federal Reserve's discount rate was predicted or because some Wall Street pundit had reversed his views on the market. Why, then, should

soon dominate his royalty stream. To suggest that this investor should sell off portions of his most successful investments simply because they have come to dominate his portfolio is akin to suggesting that the Bulls trade Michael Jordan because he has become so important to the team.

reason for that is simple: Making either type of purchase, we are searching for operations that we believe are virtually certain to possess enormous competitive strength ten or twenty years from now. A fast-changing industry environment may offer the chance

Your goal as an investor should simply be to purchase, at a rational price, a part interest in an easily-understandable business whose earnings are virtually certain to be materially higher five, ten and twenty years from now. Over time, you will find only a few companies that meet these standards-so when you see one that qualifies, you should buy a meaningful amount of stock. You must also resist the temptation to stray from your guidelines: If you aren't willing to own a stock for ten years, don't even think about owning it for ten minutes. Put together a portfolio of companies whose aggregate earnings march upward over the years, and so also will the portfolio's market value.

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Let me add a few thoughts about your own investments. Most investors, both institutional and individual, will find that the best way to own common stocks is through an index fund that charges minimal fees. Those following this path are sure to beat the net results (after fees and expenses) delivered by the great majority of investment professionals.

butt" approach to investing. A cigar butt found on the street that has only one puff left in it may not offer much of a smoke, but the "bargain purchase" will make that puff all profit.

Unless you are a liquidator, that kind of approach to buying businesses is foolish. First, the original "bargain" price probably will not turn out to be such a steal after all. In a difficult business, no sooner is one problem solved than another surfaces-never is there just one cockroach in the kitchen. Second, any initial advantage you secure will be quickly eroded by the low return that the business earns. For example, if you buy a business for $8 million

[O]ccasional outbreaks of those two super-contagious diseases, fear and greed, will forever occur in the investment community. The timing of these epidemics will be unpredictable. And the market aberrations produced by them will be equally unpredictable, both as to duration and degree. Therefore, we never try to anticipate the arrival or departure of either disease. Our goal is more modest: we simply attempt to be fearful when others are greedy and to be greedy only when others are fearful.

The calculation of intrinsic value, though, is not so simple. As our definition suggests, intrinsic value is an estimate rather than a precise figure, and it is additionally an estimate that must be changed if interest rates move or forecasts of future cash flows are revised. Two people looking at the same set of facts, moreover-and this would apply even to Charlie and me-will almost inevitably come up with at least slightly different intrinsic value figures. That is one reason we never give you our estimates of intrinsic value. What our annual reports do supply, though, are the facts

advice. Let us repeat what we said at the outset: If you want to speculate do so with your eyes open, knowing that you will probably lose money in the end; be sure to limit the amount at risk and to separate it completely from your investment program.

We are convinced that the average investor cannot deal successfully with price movements by endeavoring to forecast them. Can

A serious investor is not likely to believe that the day-to-day or even month-to-month fluctuations of the stock market make him richer or poorer. But what about the longer-term and wider changes? Here practical questions present themselves, and the psychological problems are likely to grow complicated. A substantial rise in the market is at once a legitimate reason for satisfaction and a cause for prudent concern, but it may also bring a strong temptation toward imprudent action. Your shares have advanced, good!

You are richer than you were, good! But has the price risen *too* high, and should you think of selling? Or should you kick yourself for not having bought more shares when the level was lower? Or—worst thought of all—should you now give way to the bull-market atmosphere, become infected with the enthusiasm, the overconfidence and the greed of the great public (of which, after all, you are a part), and make larger and dangerous commitments? Presented thus in print, the answer to the last question is a self-evident *no*, but even the intelligent investor is likely to need considerable will power to keep from following the crowd.

There are two chief morals to this story. The first is that the stock market often goes far wrong, and sometimes an alert and courageous investor can take advantage of its patent errors. The other is that most businesses change in character and quality over the years, sometimes for the better, perhaps more often for the worse. The investor need not watch his companies' performance like a hawk; but he should give it a good, hard look from time to time.

The speculator's primary interest lies in anticipating and profiting from market fluctuations. The investor's primary interest lies in acquiring and holding suitable securities at suitable prices. Market

The investor with a portfolio of sound stocks should expect their prices to fluctuate and should neither be concerned by sizable declines nor become excited by sizable advances. He should always remember that market quotations are there for his convenience, either to be taken advantage of or to be ignored. He should never buy a stock *because* it has gone up or sell one *because* it has gone down. He would not be far wrong if this motto read more simply: "Never buy a stock immediately after a substantial rise or sell one immediately after a substantial drop."