Berkshire Hathaway and Junk Bonds

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By Warren Buffett

In a section of his upcoming annual letter to shareholders separate from the derivatives discussion, Buffett talks about stocks, cash, and the lure of junk bonds. A list of Berkshire’s major common stock investments (those with a market value of more than $500 million at the end of 2002) will be posted on March 8, on www.berkshirehathaway.com.

Last year we were ... able to make sensible investments in a few “junk” bonds and loans. Overall, our commitments in this sector sextupled, reaching $8.3 billion by year-end.

Investing in junk bonds and investing in stocks are alike in certain ways: Both activities require us to make a price-value calculation and also to scan hundreds of securities to find the very few that have attractive reward/risk ratios. But there are important differences between the two disciplines as well. In stocks, we expect every commitment to work out well because we concentrate on conservatively financed businesses with strong competitive strengths, run by able and honest people. If we buy into these companies at sensible prices, losses should be rare. Indeed, during the 38 years we have run the company’s affairs, gains from the equities we manage at Berkshire (that is, excluding those managed at General Re/Cologne and GEICO) have exceeded losses by a ratio of about 100 to one.

Purchasing junk bonds, we are dealing with enterprises that are far more marginal. These businesses are usually overloaded with debt and often operate in industries characterized by low returns on capital. Additionally, the quality of management is sometimes questionable. Management may even have interests that are directly counter to those of debtholders. Therefore, we expect that we will have occasional large losses in junk issues. So far, however, we have done reasonably well in this field.