Berkshire Hathaway shareholders have come to expect two things of their annual report: good news (book value has increased from $19 to $737 per share in the last 18 years) and the orthodox letter of their chairman, Warren Buffett (who took over 18 years ago). Indeed, the chairman's letter practically is the Berkshire Hathaway annual report.

Shareholders get no photographs, no colored inks or foil embossing, no bar charts or graphs—not even a logo. It looks like the end of annual you see from a company whose bubble has finally burst, only Berkshire Hathaway, an insurer with major holdings in several other industries, is no bubble; at $35 a share, up from $85 six years ago, it shows no signs of bursting.

The conventional wisdom in reading annual reports is to glance at the auditor's opinion, then check the financial results and the footnotes. Is the chairman's letter? Save your time. Yet such interest are Warren Buffett's letters that they have drawn a sophisticated following. Requests for reprints even! The company has assembled a compendium of the past to meet the demand.

"They're wonderful," says Leon Levy of Levy Partners, no minor Wall Street legend himself, whereupon he recounts the passage in the last letter that most amused him: "the one in which Buffett says he didn't have wanted any part of the acquisition most others were making in 1982. "For many of these acquisitions," Buffett es, "managerial intellect wilted in common with managerial adrenaline. The idea of the chase blinded pursuers to the consequences of the catch. Pascal's observation is apt: 'It has struck me that all misfortunes spring from the single fact that they are unable to stay quietly in rooms.' (Your chairman left the room too often last year and almost starred in
the Acquisition Follies of 1982. In retrospect our major accomplishment of the year was that a very large purchase to which we had firmly committed [fell through] for reasons totally beyond our control. Had it come off, this transaction would have consumed extraordinary amounts of time and energy, all for a most uncertain payoff. If we were to introduce graphics to this report, illustrating favorable business developments of the past year, two blank pages depicting this blown deal would be the appropriate centerpiece.)

"I love that," beams Levy.

Buffett himself says he tries to talk to shareholders as if they were his partners. "I assume I've got a very intelligent partner who has been away for a year and needs to be filled in on all that's happened." He also assumes little turnover among his 2,000 shareholders. "Rather than repeat the same things each year," he says, "I take up topics that further their education." It is an exercise he seems clearly to enjoy—the letters, currently running around 12 printed pages, get longer every year. (The other extreme may have been reached last year by Wisconsin banker Jack Puelich, another iconoclastic C.E.O., whose letter to Marshall & Ilsley shareholders read, in its entirety: "Your company had a very good year in 1982. Some of it was due to luck; some of it was due to good planning and management. We hope you enjoy the numbers and the pictures.")

BUFFETT'S ATTENTION to his letters was sharpened by his service on an SEC panel formed in 1976 to study disclosure practices. (The committee issued a 1,200-page document that concluded the disclosure system was basically sound.) Former SEC Commissioner A. A. Sommer Jr., who chaired the committee—himself a Berkshire Hathaway shareholder—says the group felt such letters were very important. Even so, he adds, "Warren's letters are unique. Damn few C.E.O.'s are as smart in as many ways as Warren. It would be awfully hard to require that kind of discussion from all C.E.O.'s."

Does Buffett ever take on unorthodox subjects in his letters? Yes, he responds, he discusses his mistakes.

"The textile business again had a very poor year," he reported in 1977. (When Buffett first took over Berkshire Hathaway in 1965, that's all it was—a New Bedford, Massachusetts, textile manufacturer.) "We have mistakenly predicted better results in each of the last two years. Many difficulties experienced [have been] due primarily to industrial

Andrew Tobias's books include Fire and Ice, The Only Investment Guide You'll Ever Need, Getting By on $100,000 a Year, and The Invisible Bankers.

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"We continue to look for ways to expand our insurance operation," he wrote his shareholders in 1979, "but your reaction to this intent should not be unrestrained joy. Some of our expansion efforts—largely initiated by your chairman—have been lackluster, others have been expensive failures."

Buffett downplays the excellence of his own efforts but, like a proud coach, highlights it in his players. Berkshire Hathaway owns a big chunk of Geico, the auto insurer, and of that company's brass he writes: "Jack Byrne and Bill Snyder are achieving the most elusive of human goals—keeping things simple and remembering what you set out to do."

And of an 81-year-old subsidiary chief, since deceased: "Our experience has been that the manager of an already high-cost operation frequently is unconsciously resourceful in finding new ways to add overhead, while the manager of a tightly run operation usually continues to find additional methods to curtail costs, even when his costs are already well below those of his competitors. No one has demonstrated this latter ability better than Gene Abegg."

Here and there notes of sentimental pop up, but if Buffett wants to say something a little silly about the Washington Post Co., for which he delivered papers at the age of 13, or Geico, which first caught his eye at 20, it should be remembered that Berkshire's holdings in the one have risen in value from $11 million to $103 million and in the other from $47 million to $310 million, both under a decade. So he can say what he likes.

Happily, he says it with a sense of humor. "In a characteristically rash move," he writes, "we have expanded World Headquarters by 256 square feet (17%), coinciding with the signing of a new five-year lease. World Headquarters—in Omaha—has an addition to Buffett, five other people. Compact organization lets all of us spend time managing the business rather than aging each other."

Most chairmen's letters describe how everything went under the circumstances, to the shareholders they want it. Buffett focuses the negative, knowing that they will read it: In the most recent report, immediate observation that Berkshire Hathaway's year rise in book value represents a compound annual rate of growth, he writes, "You can be certain that this percentage diminishes in the future. Geometric progress eventually forces your own anchoring (He's right, of course. Maintaining that for another 18 years would mean growth book value to $22 billion and, after 18 more, to nearly $1 million per share.)"

In other words, the paper gains in the Berkshire Hathaway portfolio—up 40% in 15 years, he is careful first to subtract the taxes that would be paid if those gains were taken out.

To be sure, it's easy to be candid and deprecating when any fool can see you're terrific. What may be a tad gallant some of his peers is that Buffett's letter view not only his own performance and takes but those of the rest of the managers as well. "There are indications," he writes, "that several large insurers in 1982 for obscure reasons and res siding managers that masked significant deterioration in their underlying businesses, sucrance, as elsewhere, the reaction of managers to weak operations is weak accounting." His recurring theme rights of shareholders, as trampled on many other managers.

WELL KNOWN are the corp managers who fight hard to fend off generous tend fers. Less sharply perceive the managers who pay too much for a gain. More managers who want to exercise their domain at the expense of owners. Fett chides wryly, "might better consider career in government."

It's even worse, in his view, when the acquisition is made with stock, because the acquirer's stock so often sells in the market at a discount to its true value. The acquirer who nevertheless bargains ahead is using undervalued currency [his stock] to pay for fully valued property... Friendly in vestment bankers will reassure him as to the soundness of his actions. (Don't ask whether you need a haircut.)"
In light of the enormous premium required to buy all of a company, Buffett's strategy has been one of partial acquisition. Where another company will bid $48 a share for all of a company whose shares were yesterday selling at $25, Buffett is content to buy quietly at $25. "What really makes us dance," he admits, is to buy 100% of a business at a good price, but that is awfully hard to do. And so it is that at year-end Berkshire Hathaway owned, among other holdings, chunks of Blue Chip Stamps (60%), Geico (35%), General Foods (4%), precious metals fabricator Handy & Harman (17%), R.J. Reynolds (2.7%), Interpublic (15%), Ogilvy & Mather (9%), Time Inc., publisher of Fortune (2.7%), and the Washington Post Co. (13%).

Berkshire Hathaway's reported earnings include its share of the earnings at Blue Chip Stamps—which it is merging with—but only the dividend income from the other companies in its investment portfolio. So Buffett must each year remind shareholders that reported profits exclude a large portion of true earning power. "This is not a criticism of accounting procedures," he hastens to add. "We would not like to have the job of designing a better system. It's simply to say that managers and investors alike must understand that accounting numbers are the beginning, not the end, of business valuation."

AMENDING the complexities of accounting, he reveals that "the Yano-mamo Indians employ only three numbers: one, two, and more than two. Maybe their time will come."

Because of the growing importance of the company's nonconsolidated holdings, Buffett argues, it's no longer appropriate for shareholders to gauge Berkshire's performance by the ratio of reported earnings to equity, as until recently he had been advising they should. But then he adds: "You should be suspicious of such an assertion. Yardsticks seldom are discarded while yielding favorable readings. But when results deteriorate, most managers favor disposition of the yardstick rather than disposition of the manager. To managers faced with such deterioration, a more flexible measurement system often suggests itself: just shoot the arrow of business performance into a blank canvas and then carefully draw the bull's-eye around the implanted arrow. We generally believe in pre-set, long-lived, and small bull's-eyes."

One of the bull's-eyes he considers notably unimpressive is the widely trumpeted achievement of "record earnings." "I'll forever," he explains, "even a totally dead savings account will produce steady interest earnings each year because of compounding."

It's no surprise that Buffett would chide shareholders' rights; at 52, he has been a professional shareholder himself and his wife owns shares in Berkshire Hathaway recently worth $460 million, and I shire Hathaway is itself largely in the name of owning shares.

Author Jerry Goodman, in Supermoney, labels Buffett "easily the outstanding manager of the generation," noting that partnership he began in 1956—and has consummated foresight to close down in 1969—achieved a compound annual growth of 31%. "What was more remarkable," writes Goodman, "was that he did it with a philosophy of another generation... pure Benjamin Graham, applied with a lute consistency." The late Benjamin Graham, of course, authored The Intelligent Investor, in print almost continuously since 1949. Buffett chose Graham as a model, and years later, Graham chose Buffett to help revise his book.

Although Graham and Buffett did not see the same things, their common perception was to buy assets so cheaply that, over time, they could hardly fail to profit. This approach was a level head and hard work. "The market, like the Lord," Buffett writes, "helps those who help themselves. But unless the Lord, the market does not forgive those who know not what they do."

Buffett's strategy of partial acquisition makes sense when companies are selling in the marketplace at a substantial discount to their true value as ongoing businesses, but not when the market, as it periodically does, jumps over the moon. In 1972, with Avon in the rest selling at 60 times earnings, Berkshire had only 15% of its portfolio in equities, vs. 80% at the end of 1982. "There were as many good businesses around in 1972 as in 1982," he writes, "but the prices the stock market placed upon those businesses in 1972 looked absurd." Should the stock market keep climbing, he warns, Berkshire's "ability to utilize capital effectively in partial-ownership positions will be reduced... almost entirely eliminated. We currently are seeing early signs of this process." (Darn—another bull market.)

One problem all Buffett's letters address is the state of the property/casualty insurance industry—his core business. "For much of this century," he writes, "a large portion of the industry worked, in effect, within a legal quasi-administered pricing system fostered by insurance regulators. While price competition existed, it was not pervasive among the larger companies." That gentlemanly day, says Buffett, is gone. "Although parts of the old structure remain... the new capacity is not reluctant to use price as a prime competitive weapon. Indeed, it relishes that use. In the process, customers have learned that insurance is no longer a one-price business. They won't forget."

It is Buffett's plan to live with low volume while he waits for the shakeout that will cause prices to firm.

E IS LESS CONFIDENT, letter after letter, of the prospects for the textile industry—a capital-intensive commodity business in which periods of tight supply, and hence decent prices, come around only rarely (and then last only "the better part of a morning"). Of loyalty to his employees, however, and perhaps out of a certain nostalgia for Berkshire's roots, Buffett steadfastly refuses to abandon this business. Such behavior might seem to flout the interests of Berkshire shareholders—only, with 47% of the company stock, Buffett is able to summon a majority vote for this policy, or any other, practically all by himself. Even so, he assures his shareholders, it's not the kind of business he is eager to enter in the future.

Among the final notes in Buffett's letters is a virtual BIZNESSES WANTED classified. It tells a lot about how Warren Buffett operates. Berkshire Hathaway, Buffett writes, is looking for large, simple businesses ("if there's lots of technology, we won't understand it") with consistent earning power, little debt, management in place ("we can't supply it"), and an offering price ("we don't want to waste our time or that of the seller by talking, even preliminarily, when price is unknown.") "We will not engage in unfriendly transactions. We can promise complete confidentiality and a very fast answer as to possible interest—customarily within five minutes."

■ To write an interesting chairman's letter, it helps if you are a chairman with interesting ideas. Buffett's is a refreshing style in business as in prose.