

THE INSIDE STORY OF WARREN BUFFETT The Wizard of Omaha may well be America's best investor, but another talent is practically a secret: He's an ace at running businesses. Here's how he does it.

By Carol J. Loomis

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(FORTUNE Magazine) – WARREN BUFFETT, chairman of Berkshire Hathaway, calls the conglomerate his "canvas," and shortly, when its annual report comes out, the world will learn precisely what kind of picture this legendary investor painted in the tumultuous year of 1987. A preview: As a work of art, the year was not a minor Buffett. Berkshire – whose shareholders, I wish to say quickly and happily, have long included me – chalked up a \$464 million gain in net worth, an advance of no less than 19.5%. That is somewhat below the 23.1% annual average that Buffett has recorded since taking over the company 23 years ago. But in a year in which many professional investors had their heads handed to them, this latest example of Buffett brushwork has to rank as one more masterpiece. The annual report, which readers always comb for Buffett's once-a-year revelations about what he has been doing in the securities markets, will carry two special pieces of news. First, Buffett, who bought \$700 million of Salomon Inc. redeemable convertible preferred stock for Berkshire just before the October crash, makes it clear in his chairman's letter that he is solidly behind the investment bank's chairman, John Gutfreund. That should put an end to the persistent rumors about divisions between the two men (see box). Second, Buffett reveals that Berkshire began buying short-term Texaco bonds last year after the company went into bankruptcy, at a point when many other investors were bailing out of the bonds. At year-end Berkshire had an unrealized profit in the Texaco securities. But both that holding and the Salomon preferred (which Buffett figures to have been worth about \$685 million at year-end) are carried at cost on Berkshire's books and were nonevents as far as the company's 1987 record is concerned. Behind that record – behind Buffett, in fact – is a double-barreled story, which in all the words that have been written about him has usually been told as single-bore only. Most of the business world knows about Warren Buffett the investor. The Wizard of Omaha; the stock-picking genius who turned \$9,800, most of it saved from paper routes, into a personal net worth that is today more than \$1.6 billion; the man whose superlative, long-running investment performance has become ever more difficult for the efficient-market camp to explain away as luck. That Buffett was certainly abroad in the land in 1987. Having said for more than two years that he could not find reasonably priced stocks to buy for Berkshire, Buffett came into October 19 wearing heavy armor, owning almost no common equities besides those of three companies that he thinks of as "permanent" parts of Berkshire's portfolio. All three, though they fell substantially in the crash, were standouts for the entire year: Geico, the auto insurance company, was up by 12%; Washington Post by 20%; Capital Cities/ABC by 29%. Not bad for Buffett the investor. But the other craftsman at work in Berkshire is Buffett the businessman, a buyer and manager of companies and a fellow whose skill is not understood widely at all. In effect, this guy grinds out the yardage, while Buffett the investor throws bombs. In 1987 the Berkshire offense was nicely balanced: The investor produced \$249 million (after allowances for taxes) in realized and unrealized gains; the businessman generated \$215 million in after-tax operating earnings from Berkshire's stable of businesses, for that total of \$464 million. The operating earnings were more than the net income of Dow Jones, or Pillsbury, or Corning Glass Works. The vehicle through which all this got done, Berkshire, had a stock price of around \$12 in 1965 when Buffett took control. It rose to a high of \$4,200 in 1987 and was recently about \$3,100. Buffett, a witty, straightforward man of 57, owns 42% of the company; his wife, Susan, 55, another 3%. Berkshire had more than \$2 billion in revenues in 1987, will probably rank around 30th in FORTUNE's annual list of the largest diversified services companies, and is powerfully strange in its makeup. At Berkshire's heart is a large property-and-casualty insurance operation composed of several unfamous companies (such as National Indemnity), which generates "float" that Buffett invests. Beyond insurance, Berkshire owns a set of sizable businesses that Buffett bought, one by one, and that he calls his Sainted Seven. They are the Buffalo News; Fechheimer Brothers, a Cincinnati manufacturer and distributor of uniforms; the Nebraska Furniture Mart, an Omaha retailer that sells more home furnishings than any other store in the country; See's Candies, the dominant producer and retailer of candy in California; and three operations that Buffett took into the fold when Berkshire bought Scott & Fetzer of Cleveland in 1986: World Book, Kirby vacuum cleaners, and a diversified manufacturing operation that makes industrial products such as compressors and burners. A MOTLEY CREW, yes – but in his 1987 annual report, Buffett the businessman comes out of the closet to point out just how good these enterprises and their managers are. Had the Sainted Seven operated as a single business in 1987, he says, they would have employed \$175 million in equity capital, paid only a net \$2 million in interest, and earned, after taxes, \$100 million. That's a return on equity of 57%, and it is exceptional. As Buffett says, "You'll seldom see such a percentage anywhere, let alone at large, diversified companies with nominal leverage." A business school professor trying gamely a few years ago to reconcile the efficient-market hypothesis with Buffett's success at investing called him "a five-sigma event," a statistical aberration so rare it practically never happens. In the buying and managing of whole companies, he may well be a phenomenon equally uncommon. He brings to buying the same acuity and discipline he brings to investing. As a manager he disregards form and convention and sticks to business principles that he calls "simple, old, and few." The Berkshire companies, for example, never lose sight of what they're trying to do. Says Buffett: "If we get on the main line, New York to Chicago, we don't get off at Altoona and take side trips. We also have a reverence for logic around here. But what we do is not beyond anybody else's competence. I feel the same way about managing that I do about investing: It's just not necessary to do extraordinary things to get extraordinary results." My credentials for writing about both Buffetts, the investor and the businessman, are unusual. Besides having been a staff member of this magazine for more than 30 years, I have been a friend of Buffett's for more than 20. I do some editing of his annual report, which is why I know what it's going to say. I am an admirer of Buffett's. In this article, because it has been written by a friend, you can expect two things: an inside look at how Warren Buffett operates and something less than total objectivity. But here is an incontestable fact: Buffett brings an immense mental brilliance to everything he does. Michael Goldberg, 41, who runs Berkshire's insurance operations and occupies the office next to Buffett's in Omaha, thinks that he saw people as smart at the Bronx High School of Science, "but they all went into math and physics." Buffett's intellectual power is totally focused on business, which he loves and knows incredible amounts about. Says Goldberg: "He is constantly examining all that he hears: 'Is it consistent and plausible? Is it wrong?' He has a model in his head of the whole world. The computer there compares every new fact with all that he's ever experienced and knows about – and says, 'What does this mean for us?'" For Berkshire, that is. Buffett owns a few stocks personally but spends little time thinking about them. Says he: "My ego is wrapped up with Berkshire. No question about that." Meeting him, most people would see little evidence of ego at all. Buffett is down-to-earth, ordinary looking in a pleasant, solid Midwestern way – as a

private eye, for example, he could blend into any crowd -- and in matters of dress not snappy. He likes McDonald's and cherry Cokes and dislikes large parties and small talk. But in the right setting he can be highly gregarious and even a ham: This winter, at a Cap Cities management meeting, he donned a Salvation Army uniform, tooted away on a horn, and serenaded the company's chairman, Thomas Murphy, by singing, "What a friend I have in Murphy," featuring lyrics he had written. SOMETIMES, and particularly on intellectual subjects, Buffett talks with great intensity and speed, trying to keep up with the gyration in his mind. When he was young, he was terrified of public speaking. So he forced himself to take a Dale Carnegie course, filled, he says, "with other people equally pitiful." Today he gives speeches with ease, drawing them entirely from an outline in his head -- no written speech, no notes -- and lacing them with an inexhaustible supply of quips, examples, and analogies (for which a professional writer would kill). In his work Buffett has not let the complexities of his thinking prevent him from forming a very simple view of life. The key point about the two Buffetts, the investor and the businessman, is that they look at the ownership of businesses in exactly the same way. The investor sees the chance to buy portions of a business in the stock market at a price below intrinsic value -- that is, below what a rational buyer would pay to own the entire establishment. The manager sees the chance to buy the whole business at no more than that intrinsic value. The kind of merchandise that Buffett wants is simply described also: "good businesses." To him that essentially means operations with strong franchises, above-average returns on equity, a relatively small need for capital investment, and the capacity therefore to throw off cash. That list may sound like motherhood and apple pie. But finding and buying such businesses isn't easy; Buffett likens the hunt to bagging "rare and fast-moving elephants." He has avoided straying from his strict criteria. The Sainted Seven all possess the characteristics of a good business. So do the companies in which Buffett owns stock, such as Geico, Washington Post, and Cap Cities. In his annual reports Buffett regularly extols the managers of all these companies, most of whom rival him -- if anyone can -- in their conviction that working is fun. He devoutly wishes to keep them fanatics. "Wonderful businesses run by wonderful people" is his description of the scene he wants to look down on as a chief executive. But he believes that over the years his largest mistakes in investing have been the failure to buy certain "good business" stocks just because he couldn't stomach the quality of management. "I'd have been better off trusting the businesses," he says. So in the stocks he has sometimes held, though not in the businesses he owns directly, he has on occasion gritted his teeth and tolerated a fair amount of management inanity. A few years ago, when he owned many more stocks than now, he complained to a friend about the absurdities of an annual report he had just read, describing the content as misleading and self-serving of management and "enough to make you throw up." The friend said, "And yet you're in the stock." Yes, was his answer: "I want to be in businesses so good that even a dummy can make money." Naturally, good businesses do not come cheap, particularly not today when the whole world has caught on to their attributes. But Buffett has been consistently shrewd as a buyer -- he simply will not overpay -- and patient in waiting for opportunities. He regularly puts an "ad" in his annual report explaining what kind of businesses he'd like to buy. "For the right business -- and the right people -- we can provide a good home," he says. Some folks of the right sort, by the name of Heldman, read that ad and brought him their uniform business, Fechheimer, in 1986. The business had only about \$6 million in profits, which is an operation smaller than Buffett thinks ideal. But the Heldmans seemed so completely the kind of managers he looks for -- "likable, talented, honest, and goal-driven" is his description -- that he made the acquisition and is delighted he did. IN BUYING at least one business, the Buffalo News, Buffett was particularly farseeing. Both the Washington Post Co. and Chicago's Tribune Co. turned it down when it came up for sale in 1977, perhaps discouraged because it was an evening paper, a dwindling breed. The News was also a six-day publisher, with no Sunday edition and revenue stream, competing against a seven-day publisher, the Courier-Express. But the News was the stronger of the two during the week, and Buffett concluded the paper had the makings to do well if it could establish a Sunday edition. Buying the paper for \$32.5 million, he immediately started to publish on Sunday. The News's special introductory offers to subscribers and advertisers prompted the Courier-Express to bring an antitrust suit, which he defeated. Both papers went for years losing money -- and then, in 1982, the Courier-Express gave up and closed down. Last year the News, as a flourishing monopoly paper, made \$39 million in pretax operating profits and certainly did not do it by stinting on editorial copy. The paper delivers one page of news for every page of advertising, a proportion not matched by any other prosperous paper of its size or larger. Because Buffett loves journalism -- he says that if he had not been an investor, he might well have picked journalism as a career -- the News is probably his favorite property. The oddity of Buffett's intense focus on good businesses is that he came late to that philosophy, after a couple of decades of mucking around and making prodigious amounts of money anyway. As a kid in Omaha, he was precocious and fascinated by anything having to do with numbers and money. His father, Howard Buffett, a stockbroker whom the son adored, affectionately called him "Fireball." He virtually memorized a library book, One Thousand Ways to Make \$1000, fantasizing in particular about penny weighing machines. He pictured himself starting with a single machine, pyramiding his take into thousands more, and turning himself into the world's youngest millionaire. In Presbyterian church he calculated the life spans of the composers of hymns, investigating whether their religious calling had rewarded them with extra years of life (his conclusion: no). At age 11 he and a friend moved into more secular pursuits, putting out a horse-racing handicapping sheet under the name Stable-Boy Selections. Through it all he thought about stocks. He got his first books on the market when he was 8, bought his first stock (Cities Service preferred) at 11, and went on to experiment with all manner of trading methodologies. He was a teenage stock "chartist" for a while, and later a market timer. His base from 1943 on was Washington, where his family moved upon Howard Buffett's election to Congress. Deeply homesick for Omaha, young Warren once ran away from home and also got disastrous grades for a while in junior high, even in the math at which he was naturally gifted. Only when his father threatened to make Warren give up his lucrative and much-loved paper routes did his grades improve. Graduating from high school at 16, Buffett went through two years at the University of Pennsylvania and then transferred to the University of Nebraska. There, in early 1950, while a senior, he read Benjamin Graham's newly published book, The Intelligent Investor. The book encouraged the reader to pay attention to the intrinsic value of companies and to invest with a "margin of safety," and to Buffett it all made enormous sense. To this day there is a Graham flavor to Buffett's only articulated rules of investment: "The first rule is not to lose. The second rule is not to forget the first rule." In the summer of 1950, having applied to Harvard business school, Buffett took the train to Chicago and was interviewed by a local alum. What this representative of higher learning surveyed, Buffett says, was "a scrawny 19-year-old who looked 16 and had the social poise of a 12-year-old." After ten minutes the interview was over, and so were Buffett's prospects of going to Harvard. The rejection stung. But Buffett now considers it the luckiest thing ever to have happened to him, because upon returning to Omaha he chanced to learn that Ben Graham was teaching at Columbia's business school, and immediately -- and this time successfully -- applied. Another student in Graham's class was William Ruane, who today runs the top-performing Sequoia Fund and is one of Buffett's closest friends. Ruane says that a kind of intellectual electricity coursed between Graham and Buffett from the start and that the rest of the class was mainly an audience. At the end of the school year Buffett offered to work for Graham's investment company, Graham-Newman, for nothing -- "but Ben," says Buffett, "made his customary calculation of value to price and said no." Buffett did not succeed in getting a job offer from Graham until 1954, when he started at Graham-Newman as jack-of-all-trades and student of his mentor's mechanistic, value-based investment techniques. Basically, Graham looked for "bargains," which he rigidly defined as stocks that could be bought at no more than two-thirds of their net working capital. Most companies, he figured, could be liquidated for at least their net working capital; so in buying for still less, he saw himself building in the necessary margin of safety. Today few stocks would

meet Graham's standards; in the early 1950s, many did. Buffett returned to Omaha in 1956 at age 25, imbued with Graham's theories and ready to embark upon the course that was to make him rich and famous. Assembling \$105,000 in limited partnership funds from a few family members and friends, he started Buffett Partnership Ltd. The economics of the partnership were simple: The limited partners earned 6% on their funds and got 75% of all profits made in addition; Buffett, as general partner, got the remaining 25%. The partnership earned impressive profits from the start, and as word spread about this young man's abilities, new partners climbed aboard, bearing money. When Buffett decided in 1969 to disband the partnership, having grown disenchanted with a market that had turned wildly speculative, he had \$100 million under management, of which \$25 million was his own -- most of it the fruits of his share of the profits. Over the 13 years of the partnership, he had compounded its funds at an average annual rate of 29.5%. That record is the forerunner of his performance with Berkshire: 23.1%. The drama of his Berkshire record is that he has scored colossal gains on the company's capital while retaining 100% of its earnings -- Berkshire pays no dividends. This means that he has had to find investment outlets for a vigorously expanding amount of money. The company's equity at year-end was \$2.8 billion, an impressive figure to be compounding at superlative rates. Despite the outstanding record of the partnership, Buffett feels today that he managed its money with only part of his senses at work. In his 1987 annual report Buffett laments 20 misspent years, a period including all of the partnership days, during which he searched for "bargains" -- and, alas, "had the misfortune to find some." His punishment, he says, was "an education in the economics of short-line farm implement manufacturers, third-place department stores, and New England textile manufacturers." The farm implement company was Dempster Mill Manufacturing of Nebraska; the department store was Hochschild Kohn of Baltimore; and the textile manufacturer was Berkshire Hathaway itself. The Buffett partnership got in and out of Dempster and Hochschild Kohn quickly during the 1960s. Berkshire Hathaway, the textile business, of which the partnership bought control for around \$11 million, was a more lasting problem. Buffett nursed the business for 20 years while deploring the benightedness that had taken him into such industrial bogs as men's suit linings, in which he was just another commodity operator with no edge of any kind. Periodically Buffett would explain in his annual report why he stayed in an operation with such poor economics. The business, he said, was a major employer in New Bedford, Massachusetts; the operation's managers had been straightforward with him and as able as the managers of his successful businesses; the unions had been reasonable. But finally, in 1985, Buffett closed the operation, unwilling to make the capital investments that would have been necessary if he was even to subsist in this deeply discouraging business. A few years earlier, for his annual report, Buffett wrote a line that has become famous: "With few exceptions, when a manager with a reputation for brilliance tackles a business with a reputation for poor fundamental economics, it is the reputation of the business that remains intact." As a requiem for Buffett's textile experience, the sentiment will do nicely. In his own mind, also, this is not just a case of a relatively small investment gone bad. Calculating what Berkshire might have earned if he had not made the bet on textiles, he thinks of the opportunity cost as being around \$500 million. OCCASIONALLY during his misspent years, Buffett would be drawn toward a good business and, as if startled into unusual action, would plunge abnormal amounts into the opportunity. In 1951, then investing only his own money and mainly gravitating toward such "bargains" as Timely Clothes and Des Moines Railway, Buffett became fascinated by Geico, whose low distribution costs and ability to sign up a better set of policyholders than other insurers gave it a crucial advantage. Though the company did not begin to meet Ben Graham's mathematical tests, Buffett put \$10,000 -- around two-thirds of his net worth -- into Geico stock. He sold a year later at a 50% profit and did not again own the company until 1976. By then Geico was magnitudes larger but near bankruptcy because it had miscalculated its claim costs and was underpricing. Buffett thought, however, that the company's competitive advantage was intact and that a newly named chief executive, John J. Byrne, could probably restore the company's health. Over five years Buffett invested \$45 million in Geico. Byrne did the job, becoming a close friend of Buffett's and often seeking his advice. Geico is today an industry star, and Berkshire's stake is worth \$800 million. On another occasion, in 1964, while running the partnership, Buffett barreled into American Express stock at the time of the so-called salad oil scandal. An Amexco subsidiary that issued warehouse receipts was found to have certified the existence of mountainous quantities of oil that did not exist. On a worst-case basis American Express might have emerged from that crisis with no net worth. The company's stock plunged. Ben Graham would have scomed the stock because, by his definitions, it offered no margin of safety. But Buffett assessed the franchises embodied in the company's charge card and traveler's checks businesses and concluded these were assets that could carry Amexco through almost any storm. Buffett had an unwritten rule at the time that he would not put more than 25% of the partnership's money into one security. He broke the rule for American Express, committing 40%, which was \$13 million. Some two years later he sold out at a \$20 million profit. Buffett considers himself to have been nudged, prodded, and shoved toward a steady, rather than intermittent, appreciation of good businesses by Charles T. Munger, 64, vice chairman of Berkshire and the "Charlie" of Buffett's annual reports. In the U.S. corporate system, vice chairmen have a way of often not being important. That is decidedly not the case at Berkshire Hathaway. Munger's mental ability is probably up to Buffett's, and the two can talk as equals. They differ, however, in political views -- Munger is a traditional Republican, Buffett a fiscally conservative Democrat -- and in demeanor. Though sometimes cutting in his annual report, Buffett employs great tact when doling out criticism in person. Munger can be incisively frank. Last year, chairing the annual meeting of Wesco, a California savings and loan 80% owned by Berkshire, Munger delivered a self-appraisal: "In my whole life nobody has ever accused me of being humble. Although humility is a trait I much admire, I don't think I quite got my full share." Like Buffett, Munger is a native of Omaha, but as boys the two did not know each other. After getting the equivalent of a college degree in the Army Air Force and graduating from Harvard law school, Munger went to Los Angeles, where he started the law firm now known as Munger Tolles & Olson. On a visit back to Omaha in 1959, Munger attended a dinner party that also included Buffett. Munger had heard tales of this 29-year-old who was remaking the Omaha investment scene and was prepared to be unimpressed. Instead, he was bowled over by Buffett's intellect. "I would have to say," says Munger, "that I recognized almost instantly what a remarkable person Warren is." Buffett's reaction was that of a proselytizer. Convinced that the law was a slow boat to wealth, he began arguing that Munger should give up his practice and start his own investment partnership. Finally, in 1962, Munger made the move, though he hedged his bets by also keeping a hand in the law. His partnership was much smaller than Buffett's, more highly concentrated, and much more volatile. Nonetheless, in the partnership's 13-year history, extending through 1975, Munger achieved an annual average gain, compounded, of 19.8%. His wealth expanded as Buffett expected: Among other holdings, he owns nearly 2% of Berkshire, recently worth about \$70 million. When he met Buffett, Munger had already formed strong opinions about the chasms between good businesses and bad. He served as a director of an International Harvester dealership in Bakersfield and saw how difficult it was to fix up an intrinsically mediocre business; as an Angeleno, he observed the splendid prosperity of the Los Angeles Times; in his head he did not carry a creed about "bargains" that had to be unlearned. So in conversations with Buffett over the years he preached the virtues of good businesses, and in time & Buffett totally accepted the logic of the case. By 1972, Blue Chip Stamps, a Berkshire affiliate that has since been merged into the parent, was paying three times book value to buy See's Candies, and the good-business era was launched. "I have been shaped tremendously by Charlie," says Buffett. "Boy, if I had listened only to Ben, would I ever be a lot poorer." Last year at a Los Angeles party, Munger's dinner partner turned to him and coolly asked, "Tell me, what one quality most accounts for your enormous success?" Recalling this delicious moment later, Munger said, "Can you imagine such a wonderful question? And so I looked at this marvelous creature -- whom I certainly hope to sit by at

every dinner party – and said, 'I'm rational. That's the answer. I'm rational.'" The anecdote has a particular relevance because rationality is also the quality that Buffett thinks distinguishes the style with which he runs Berkshire – and the quality he often finds lacking at other corporations. ESSENTIALLY, BUFFETT, as chief executive officer, does the jobs for which he judges himself to have special competence: capital allocation, pricing in certain instances, and analysis of the numbers coming out of the operating divisions. "Warren would die if he didn't get the monthly figures," says Munger. As long as the numbers are looking as they should, though, Buffett does not poke into operations, but rather leaves his managers free to run their businesses as their intelligence tells them to. When he talks about the kind of companies he wishes to buy, Buffett always stipulates that they must come in the door with their own good management because, he says, "We can't supply management, and won't." He is solicitous of the talent working for him. Most of the people heading his operations are rich and could retire. In what he writes and says, Buffett never lets them forget that he regards their continued hard work as one of the great rewards of his life. Buffett sets the pay of the top man in an operating company but plays no role in compensation beyond that. All the top people are paid through incentive plans that Buffett carefully tailors to achieve whatever objectives fit – higher profit margins in a business, for example, or reductions in the capital it employs, or improved underwriting results for the insurance operation and more "float" for Buffett to invest. The incentives do not have ceilings. And so it is that Mike Goldberg, of the insurance business, earned / \$2.6 million in 1986 and \$3.1 million last year. On the other hand, in 1983 and 1984, when the insurance business was rotten, he earned his base salary, which is roughly \$100,000. Looking ahead, and running an insurance business that is souring rapidly, Goldberg thinks he could be back at base pay again by 1990. Buffett earns base pay by all definitions: \$100,000 per year. AT THAT PRICE he offers undoubtedly the best-value consulting business around. His operating managers can call him whenever they wish with whatever concerns they have, and none pass up the opportunity to draw on his encyclopedic knowledge of the way businesses work. Stanford Lipsey, publisher of the Buffalo News, tends to talk to Buffett once or twice a week, usually at night. Ralph Schey, chairman of Scott Fetzer, says he saves up his questions, checking in with Buffett every week or two. With the family Buffett usually refers to as "the amazing Blumkins," who run the Nebraska Furniture Mart, the drill is dinner, held every few weeks at an Omaha restaurant. The Blumkins attending usually include Louie, 68, and his sons: Ron, 39; Irv, 35; and Steve, 33. The matriarch of the family and chairman of the Furniture Mart is Rose Blumkin, who emigrated from Russia as a young woman, started a tiny furniture store that offered rock-bottom prices – her motto is "Sell cheap and tell the truth" – and built it into a business that last year did \$140 million in sales. At age 94, she still works seven days a week in the carpet department. Buffett says in his new annual report that she is clearly gathering speed and "may well reach her full potential in another five or ten years. Therefore, I've persuaded the Board to scrap our mandatory-retirement-at -100 policy." And it's about time, he adds: "With every passing year, this policy has seemed sillier to me." He jests, true, but Buffett simply does not regard age as having any bearing on how able a manager is. Perhaps because he has tended to buy good managements and stick with them, he has worked over the years with an unusually large number of older executives and treasured their abilities. "My God," he says, "good managers are so scarce I can't afford the luxury of letting them go just because they've added a year to their age." Louis Vincenti, chairman of Wesco until shortly before he died at age 79, used to periodically question whether he should not be training a successor. Buffett would turn him off with a big smile: "Say, Louie, how's your mother feeling - these days?" The Berkshire companies do not in any way practice togetherness. There are no companywide management meetings and most of the operating heads do not know one another, or at most have exchanged a few words. Buffett has never visited Fechheimer in Cincinnati. Charles "Chuck" Huggins, president of See's for the 16 years Berkshire has owned it, has never been to Omaha. Naturally, Buffett does not impose any systems of management on the heads of the operating companies, who are free to be as loose or structured as they wish. Schey, 63, the chief executive of Scott Fetzer (1987 sales: \$740 million), is a graduate of Harvard business school and uses the full panoply of management tools: detailed budgets, strategic plans, annual conclaves of his executives. A few hundred miles away at Fechheimer (1987 sales: \$75 million), Robert Heldman, 69, and brother George, 67, sit down every morning in a cluttered conference room and go through all the mail that comes into headquarters. "Somebody slits it open for us, though," says Bob Heldman, not wanting to be thought an extremist. As the latest businesses to be acquired by Berkshire, Scott Fetzer and Fechheimer have been getting accustomed to dealing with this unusual boss in Omaha. A few years ago, before selling to Berkshire, Schey had attempted to lead a management buyout that would have taken Scott Fetzer, a listed company, private. But Ivan Boesky meddled in the deal, the company's fate grew uncertain, and in time Buffett wrote Schey an exploratory letter. Buffett and Munger met with Schey on a Tuesday in Chicago, made an offer on the spot, and waived the "due diligence" rigmarole that acquirers usually demand. One week later Scott Fetzer's board approved the sale. SCHEY REGARDS that episode as illustrative of the lack of bureaucracy he encounters in working with Buffett. "If I couldn't own Scott Fetzer myself, this is the next best thing" – better, he feels, than being a public company. In that life he had institutional investors on his neck and a board that tended to be ultracautious about authorizing major moves. Schey's prize example is his current intention to decentralize the World Book organization, which has been hunkered down at Chicago's Merchandise Mart forever. Schey's old board, he says, would probably have resisted the risk of restructuring; Buffett waved him ahead. Schey says, with a grin, that Buffett has also solved the recurring problems that Scott Fetzer had finding a use for all the cash) its very good businesses throw off. "Now," says Schey, "I just ship the money to Warren." The Heldmans at Fechheimer sold 80% of their company in 1981 to a venture capital group and, on the advice of an investment counselor, put part of the proceeds into Berkshire Hathaway stock. When the venture group decided in 1985 to get out, Bob Heldman recalled Buffett's annual report pitch for acquisitions and negotiated his way into the Berkshire fold. Though their relationship with the venture capitalists was pleasant, the Heldmans thoroughly disliked six New York board meetings they had to attend every year and also the lavish expense of those meetings. Buffett, says Bob Heldman, is "terrific." Is there anything that you wish he would do differently? "Well," says Heldman, "he never second-guesses us. Maybe he should do more of that." Buffett roars upon learning of this complaint: "Believe me, if they needed second-guessing – which they definitely don't – they'd get it." Buffett can actually be very tough. He recalls landing on one of the operating divisions a few years ago when it put in new "labor saving" data-processing equipment and nonetheless let its head count in the accounting department go from 16 1/2 to 22 1/2. For all of his laid-back management style, Buffett knows about numbers like that and deplores them. There is a right-size staff for any operation, he thinks, whether business is good or bad, and he is totally impatient with unnecessary costs and managers who allow them to materialize. He says: "Whenever I read about some company undertaking a cost-cutting program, I know it's not a company that really knows what costs are all about. Spurts don't work in this area. The really good manager does not wake up in the morning and say, 'This is the day I'm going to cut costs,' any more than he wakes up and decides to practice breathing." WHEN THEY CRITICIZE him, which they do only mildly, Buffett's operating managers tend to think him too rational and demanding about numbers. No one can quite imagine him paying up for a small "seed" business with a possible future but no present. Buffett and Munger are not in the least suffused with animal spirits, and they do not even consider making discretionary capital expenditures – say for flashy offices – that aren't going to do them any economic good. Neither are they inventors. Says Buffett: "We don't have the skill to be. Above all, I guess you'd say we have a strong sense of our own limitations." They are not timid, though, about prices. Buffett works with the heads of both See's and the Buffalo News in setting prices once a year, and he has tended to be aggressive. A chief executive, he says, can bring a perspective to pricing that a divisional manager cannot: "The manager has just one business. His

equation tells him that if he prices a little too low, it's not that serious. But if he prices too high, he sees himself screwing up the only thing in his life. And no one knows what raising prices will do. For the manager, it's all Russian roulette. For the chief executive, with more than one thing in his life, it really isn't. So I would argue that someone with wide experience and distance from the scene should set prices in certain cases." Buffett extends his own experience to one other kind of pricing: the setting of premium rates for large-risk insurance policies, such as product liability coverage. That game is one of seven- and eight-figure premiums, probabilities, and years of "float." It is a game made to order for Buffett, who tends to do a few calculations in his head and come up with a bid. He does not own a calculator -- "or a computer or abacus," he says -- and would never see himself as needing any kind of mathematical crutch. Though the point is hardly provable, he must be the only billionaire who still does his own income tax. At his office in Omaha, in fact, he does what he pleases, leading an unhurried, unhassled, largely unscheduled life. Counting the boss, headquarters includes only 11 people, and that's a shade too many, Buffett thinks. The place is kept efficient by his assistant, Gladys Kaiser, 59, who has worked for him 20 years and for whom he wishes perpetual life. "If Gladys can't have it," Buffett says, "I'm not sure I want it either." He spends hours at a stretch in his office, reading, talking on the phone, and, in the December to March period, agonizing over his annual report, whose fame is one of the profound satisfactions of his life. He is not in the least moody. "When I talk to him," says Chuck Huggins of See's, "he's always up, always positive." But in general he is something of a loner in his office, apt there to be less communicative and gracious than when talking on the phone to friends or the operating managers. Munger thinks it would not work for the managers to be physically in the same place as Buffett. "He's so damn smart and quick that people who are around him all the time feel a constant mental pressure from trying to keep up. You'd need a strong ego to survive in headquarters." Goldberg, whose ego has been put to the test, says it's not easy. "I've had a chance to see someone in action who can't be believed. The negative is: How do you ever think much of your own abilities after being around Warren Buffett?" When Buffett is buying stocks, he often interrupts other phone conversations to talk on three direct lines that connect him with brokers. But he will say in the new annual report that he has not found much to do in stocks lately. "During the break in October," he writes, "a few stocks fell to prices that interested us, but we were unable to make meaningful purchases before they rebounded." At year-end Berkshire held no stock positions worth more than \$50 million, other than its "permanent" holdings and a short-term \$78 million arbitrage position in Allegis, which is radically restructuring. The friends that Buffett talks to on the phone and often sees include a few other chief executives, among them the Washington Post's Katharine Graham and Cap Cities' Murphy. Graham has leaned on him for advice for years. As she says, "I'm working on my degree from the Buffett school of business." Buffett thinks Murphy the finest executive in the country, but Murphy tunes in for advice also. "I talk to him about all the important aspects of my business," says Murphy. "He's never negative and always supportive. He's got such a massive mind and such a remarkable ability to absorb information. You know, we're supposed to be pretty good managers around here, but his newspaper outdoes ours." Buffett himself thinks that his investing abilities have been helped by his business experiences, and vice versa. "Investing," he says, "gives you this wide exposure that you just can't get directly. As an investor, you learn where the surprises are -- in retailing, for example, where business can just evaporate. And if you're a really good investor you go back and pick up 50 years of vicarious experience. You also learn capital allocation. Instead of putting water in just one bucket, you learn what other buckets have to offer." "On the other hand," he goes on, "could you really explain to a fish what it's like to walk on land? One day on land is worth a thousand years of talking about it, and one day running a business has exactly the same kind of value. Running a business really makes you feel down to your toes what it's like." His summary judgment: It's been awfully good to have a foot in both camps.

BOX: THE WISDOM OF SALOMON?

"We have no special insights regarding the direction or future profitability of investment banking," says Warren Buffett in the forthcoming Berkshire Hathaway annual report for 1987. "What we do have a strong feeling about is the ability and integrity of John Gutfreund, CEO of Salomon Inc." With that declaration, Buffett takes a hatchet to the rumors that have been sweeping Wall Street for months, in which he is typically presented as wanting (a) Gutfreund out and (b) someone like William Simon in. Since Buffett has a policy of not making hostile moves against the managements of companies he invests in, the rumors were always a reach. But the timing of Buffett's push into Salomon last year almost guaranteed that stories would begin to fly. On October 1 he put \$700 million of Berkshire's money, his biggest investment ever, into Salomon redeemable convertible preferred. The stock pays 9%, is convertible after three years into Salomon common at \$38, and if not converted will be redeemed over five years beginning in 1995. The rub is the \$38. Salomon stock was around \$33 when Buffett made the deal. After October 19 it sank to almost \$16 and was recently about \$23. The crash transformed the Street's perception of Buffett's move. He was originally thought to have bought a dream security, worth more than he paid. Salomon, it was said, had panicked at the prospect that raider Ronald Perelman might try a takeover and had allowed Buffett his own bit of banditry. The postcrash reading, which takes into account many defections and much turmoil at Salomon, is that Buffett has bought a bummer and that his whole credibility as an investor is at stake. Buffett notes in his annual report that the economics of investment banking are far less predictable than those of most businesses in which he has major commitments. He says that's one reason he went for a convertible preferred. But he also sounds serene in outlook: "We believe there is a reasonable likelihood that a leading, high-quality capital-raising and market-making operation can average good returns on equity. If so, our conversion right will eventually prove valuable." By the way, he adds, he'd like to buy more convertible preferreds of the Salomon variety, which sounds like serenity squared. The most fascinating aspect of Buffett's Salomon investment is that it puts him in bed with Wall Streeters, whose general greed he has scored in the past. In his 1982 annual report he derided the inclination of investment bankers to provide whatever advice would bring in the most income. "Don't ask your barber whether you need a haircut," he said. But this year's report suggests he finds Gutfreund's barbering a cut above: In dealings with Gutfreund, Buffett says, he has seen him advise clients not to take steps they were itching to take, even though that caused Salomon to miss out on large fees. Note that Buffett's description of Salomon's business does not include those Wall Street buzzwords "merchant banking." To Buffett, the bridge loans that are the current merchant-banking fad and that grease the way for many leveraged buyouts all too often look like dangerous commitments -- debt so junior that it is almost equity. He and his associate, Charles Munger, are directors of Salomon and may well argue that the firm should avoid making bridge loans. But, says Buffett, "if John Gutfreund ends up thinking he wants to do them, we will support him. We don't go into companies with the thought of effecting a lot of change. That doesn't work any better in investments than it does in marriages."