How good is Warren Buffett?

How well does Warren Buffett really do with Berkshire Hathaway shareholder funds?

Story Graham Kenny

Warren Buffett is much in the news of late for investing $US3 billion of shareholders’ money in General Electric – to give just one example. We all know he is a very wealthy man, reputedly the wealthiest in the world. We also know that as CEO of Berkshire Hathaway, he heads up one of the world’s most diversified companies. And as a person, he seems to be very likeable, without show, a man of simple tastes who draws a salary of just over $US100,000 with no bonuses or stock options and eats in the same steakhouse in Omaha, Nebraska, twice a week. With a fortune estimated at $US62 billion, Buffett is definitely a legend of our times.

But has the legend outgrown the reality? How well does Buffett really do with the funds entrusted to him by the company’s shareholders?

BERKSHIRE HATHAWAY

Berkshire Hathaway is composed of more than 40 separate companies. At year-end 2007 it had a total revenue of $US118.2 billion, a net income of $US13.2 billion and around 180,000 employees. It owns businesses engaged in diverse activities.

A major one is property and casualty insurance, conducted on both a direct and reinsurance basis through a number of subsidiaries. Included in this group is GEICO, one of the five largest auto insurers in the United States; General Re, one of the four largest reinsurers in the world; and the Berkshire Hathaway Reinsurance Group. Insurance premiums amount to 27 per cent of total revenue.

Berkshire Hathaway also has numerous businesses outside insurance, including several large manufacturers. For example, Shaw Industries is the world’s largest manufacturer of tufted broadloom carpet and Benjamin Moore is a formulator, manufacturer and retailer of architectural and industrial coatings. It’s a huge list. In all, service and sales revenues amount to 49 per cent of total revenue.

Berkshire’s remaining investments account for the remaining 24 per cent of total revenue and are in utility and energy businesses, finance and financial products businesses, commercial and consumer lending, transportation equipment, furniture leasing and risk management activities.

The Hathaway company was started in 1888 by Horatio Hathaway, one of its businesses being to mill cotton. In the 1950s the Hathaway Manufacturing Company merged with Berkshire Fine Spinning Associates Inc. The merged company, Berkshire Hathaway, was huge for its time, with 15 plants, 12,000 employees and revenue of over $US120 million. But by the end of the 1950s, this public company had closed seven of its plants and laid off a large number of workers. Its share price had also fallen.

Enter Warren Buffett. In 1962 he started buying the company’s shares. By 1963 he and his associates had become the largest shareholder, gradually increasing their share to 49 per cent. Buffett used his voting rights to change the management of the company. The shares he had bought for $US15 were now worth $US18, but the company had been reduced to two operating mills and 2300 employees. He thought he could operate the company profitably. But it was never a success and was finally sold in 1985.

Over this period, Buffett discovered insurance – and cash. Around 1967 he purchased two Nebraska insurance companies. The cash from premiums provided him with funds to invest, but in something that was liquid. That became stocks and bonds. The purchase a few years later of GEICO (General Insurance Company) brought in a huge cash flow that would allow further stock investments.

In 1967 Berkshire Hathaway paid a dividend – of 10 cents on its outstanding stock. It never happened again. Buffett has said: “I must have been in the bathroom when the dividend was declared.” (Dividends, of course, are not a business expense, but rather a distribution of company assets to shareholders, paid out of net income.)

Buffett has preferred ever since to retain all earnings, confident in the belief that he’d do better with those earnings than his investors, and pleased to see each Berkshire Hathaway share loaded with additional asset value, increasing in market price.

Here we see Buffett’s financial model at work. His first step is to keep all cash. If you need cash, why give it away as dividends? His second step is to buy only cash-producing stocks and businesses, like Coca
Cola and Gillette. He wouldn’t consider investing in an embryonic biotech stock that may, or may not, produce products worth billions. The reason: no cash flow – and risky.

His third step also involves cash: buying businesses with large cash reserves. That has led him to the insurance industry. Insurance companies sit on mountains of cash that they may never need to pay out. Buffett’s insight was to spy the opportunity here and gain access to these cash pools by purchasing insurance companies.

His model, involving as it does cash, cash and more cash, doesn’t require the issue of additional stock to shareholders to raise cash. As a result, shareholders’ equity per share, and any other per-share measure you can name, looks good. The no-dividends policy has the two-edged effect of holding down the number of issued shares (the denominator) and increasing shareholders’ equity (the numerator).

But shareholders’ equity per share is deceptive when it comes to assessing corporate performance. To assess that we need to look at the return a firm achieves on shareholders’ funds.

RETURN ON EQUITY

Return on equity (ROE) is net profit after tax and abnormal items (NPAT, also known as net income) divided by equity, which is also known as shareholders’ equity, shareholders’ funds, net assets and net worth. These terms have various historical and national origins and are used in a variety of contexts.

Shareholders’ equity is derived from the funds contributed by shareholders in the initial purchase of shares plus any funds retained by the company from profits that are not paid to shareholders as dividends – called retained earnings. So a ROE number provides us with an assessment of how well a firm uses shareholders’ money. This can then be compared to alternative investment opportunities. Moreover, ROE is a number that is devoid of sharemarket hype.

Standard & Poor’s Quality Rankings divides stocks into categories: A+, A, A-, down to C. Standard & Poor’s has been amassing this data since 1956. A- is above average. The ROE for this category is 14 per cent. Warren Buffett is a great advocate of measuring return on equity and employs it as one of six criteria in selecting a stock for investment. He has also suggested 14 per cent as a desirable target. Yet he fails to achieve it for his own company!

In my book, Diversification Blueprint, I applied this benchmark figure to the recent 10 years of ROE history in a number of business cases. While other companies passed the hurdle for all 10 years, Berkshire Hathaway never passed the grade once in the 10 years. Its figures ranged from 1.3 per cent in 2001 to 12.7 per cent in 2003 and averaged 7.8 per cent over the whole period.

There is no doubt that the high-cash-flow, no-dividend model has been a winner for Warren Buffett personally. But there’s nothing in his approach to investing – based as it is on Benjamin Graham’s book, The Intelligent Investor – that hasn’t been known and applied for decades. He’s become rich because of a clever financial model that has allowed him to grow Berkshire Hathaway and at the same time retain significant ownership, 31 per cent of the company.

But Warren Buffett has not done well with shareholders’ funds. Canada’s The Globe and Mail of August 15, 2008, in an article titled “Is Berkshire’s Star Fading?”, reports the first signs of a business model found wanting: the company posted losses for the third quarter in a row.

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