

# BUFFETT PARTNERSHIP, LTD.

610 KIRWIT PLAZA  
OMAHA 31, NEBRASKA  
TELEPHONE 346-4110

January 24, 1962

WARREN E. BUFFETT, GENERAL PARTNER  
WILLIAM SCOTT

## Our Performance in 1961

I have consistently told partners that it is my expectation and hope (it's always hard to tell which is which) that we will do relatively well compared to the general market in down or static markets, but that we may not look so good in advancing markets. In strongly advancing markets I expect to have real difficulty keeping up with the general market.

Although 1961 was certainly a good year for the general market and, in addition, a very good year for us on both an absolute and relative basis, the expectations in the previous paragraph remain unchanged.

During 1961, the general market as measured by the Dow-Jones Industrial Average (hereinafter called the "Dow") showed an over-all gain of 22.2% including dividends received through ownership of the Dow. The gain for all partners operating throughout the entire year, after all expenses of operation, but before payments to limited partners or accrual to the general partner, averaged 45.9%. The details of this gain by partnership are shown in the appendix along with results for the partnerships started during the year.

We have now completed five full years of partnership operation, and the results of these five years are shown below on a year-by-year basis and also on an absolute or compounded basis. These results are stated on the basis described in the preceding paragraph; after expenses, but before division of gains among partners or payments to partners.

<u>Year</u>	<u>Partnerships Operating Entire Year</u>	<u>Partnership Gain</u>	<u>Dow-Jones Industrials Gain *</u>
1957	3	10.4%	-8.4%
1958	5	40.9	38.5
1959	6	25.9	18.9
1960	7	22.8	-6.3
1961	7	45.9	22.2

\* Including dividends received through ownership of the Dow.

On a compounded basis, the cumulative results have been:

<u>Year</u>	<u>Partnership Gain</u>	<u>Dow-Jones Industrials Gain</u>
1957	10.4%	-8.4%
1957-8	55.6	26.9
1957-9	95.9	52.2
1957-60	140.6	42.6
1957-61	251.0	74.3

These results do not measure the gain to the limited partner, which of course, is the figure in which you are most interested. Because of the varying partnership arrangements that have existed in the past, I have used the over-all net gain (based on market values at the beginning and end of the year) to the partnership as being the fairest measure of over-all performance.

On a pro-forma basis adjusted to the division of gains entailed in our present Buffett Partnership, Ltd. agreement, the results would have been:

<u>Year</u>	<u>Limited Partners' Gain</u>	<u>Dow Gain</u>
1957	9.3%	-8.4%
1958	32.2	38.5
1959	20.9	19.9
1960	18.6	-6.3
1961	35.9	22.2

#### COMPOUNDED

1957	9.3%	-8.4%
1957-8	44.5	26.9
1957-9	74.7	52.2
1957-60	107.2	42.6
1957-61	181.6	74.3

#### A Word About Par

The outstanding item of importance in my selection of partners, as well as in my subsequent relations with them, has been the determination that we use the same yardstick. If my performance is poor, I expect partners to withdraw, and indeed, I should look for a new source of investment for my own funds. If my performance is good, I am assured of doing splendidly, a state of affairs to which I am sure I can adjust.

The rub, then, is in being sure that we all have the same ideas of what is good and what is poor. I believe in establishing yardsticks prior to the act; retrospectively, almost anything can be made to look good in relation to something or other.

I have continuously used the Dow-Jones Industrial Average as our measure of performance. It is my feeling that three years is a very minimal test of performance, and the best test consists of a period at least that long where the terminal level of the Dow is reasonably close to the initial level.

While the Dow is not perfect (nor is anything else) as a measure of performance it has the advantage of being widely known, has a long period of continuity, and reflects with reasonable accuracy the experience of investors generally with the market. I have no objection to any other method of measurement of general market performance being used, such as other stock market averages, leading diversified mutual stock funds, bank common trust funds, etc.

You may feel I have established an unduly short yardstick in that it perhaps appears quite simple to do better than an unmanaged index of 30 leading common stocks. Actually, this index has generally proven to be a reasonably tough competitor. Arthur Wiesenberger's classic book on investment companies lists performance for the 15 years, 1946-60, for all leading mutual funds. There are presently over \$20 billion invested in mutual funds, so the experience of these funds represents, collectively, the experience of many million investors. My own belief, though the figures are not obtainable, is that portfolios of most leading investment counsel organizations and bank trust departments have achieved results similar to these mutual funds.

Wiesenberger lists 70 funds in his "Charts & Statistics" with continuous records since 1946. I have excluded 32 of these funds for various reasons since they were balanced funds (therefore not participating fully in the general market rise) or specialized industry funds, etc. Of the 32 excluded because I felt a comparison would not be fair, 31 did poorer than the Dow, so they were certainly not excluded to slant the conclusions below.

Of the remaining 38 mutual funds whose method of operation I felt was such a make a comparison with the Dow reasonable, 32 did poorer than the Dow, and 6 did better. The 6 doing better at the end of 1960 had assets of about \$1 billion and the 32 doing poorer had assets of about \$6-1/2 billion. None of the six that were superior beat the Dow by more than a few percentage points a year.

Below I present the year-by-year results for our period of operation (excluding 1961 for which I don't have exact data, although rough figures indicate no variation from the 1957-60 figures) for the two largest common stock open-end investment companies (mutual funds) and the two largest closed-end investment companies

Year	Mass. Inv. Trust	Investors Stock	Lehman	Tri-Cont.	Dow	Limited Partners
1957	-12.0%	-12.4%	-11.4%	- 2.4%	- 8.4%	+ 9.3%
1958	+44.1	+47.6	+40.8	+33.2	+38.5	+32.2
1959	+ 8.2	+10.3	+ 8.1	+ 8.4	+19.9	+20.9
1960	- 0.9	- 0.1	+ 2.6	+ 2.8	- 6.3	+18.6

## COMPOUNDED

<u>Year</u>	<u>Mass. Inv. Trust</u>	<u>Investors Stock</u>	<u>Lehman</u>	<u>Tri-Cont.</u>	<u>Dow</u>	<u>Limited Partners</u>
1957	-12.0%	-12.4%	-11.4%	- 2.4%	- 8.4%	+ 9.3%
1957-8	+26.8	+29.3	+24.7	+30.0	+26.9	+44.5
1957-9	+37.2	+42.6	+34.8	+40.9	+52.2	+74.7
1957-60	+36.0	+42.5	+38.3	+44.8	+42.6	+107.2

Massachusetts Investors Trust has net assets of about \$1.8 billion; Investors Stock Fund about \$1 billion; Tri-Continental Corporation about \$.5 billion; and Lehman Corporation about \$350 million; or a total of over \$3.5 billion.

I do not present the above tabulations and information with the idea of indicting investment companies. My own record of investing such huge sums of money with restrictions on the degree of activity I might take in companies where we had investments, would be no better, if as good. I present this data to indicate the Dow as an investment competitor is no pushover, and the great bulk of investment funds in the country are going to have difficulty in bettering, or perhaps even matching, its performance.

Our portfolio is very different from that of the Dow. Our method of operation is substantially different from that of mutual funds.

However, most partners, as an alternative to their investment in the partner would probably have their funds invested in a media producing results comparable to the Dow, therefore, I feel it is a fair test of performance.

### Our Method of Operation

Our avenues of investment break down into three categories. These categories have different behavior characteristics, and the way our money is divided among them will have an important effect on our results, relative to the Dow in any given year. The actual percentage division among categories is to some degree planned, but to a great extent, accidental, based upon availability factors.

The first section consists of generally undervalued securities (hereinafter called "generals") where we have nothing to say about corporate policies and no timetable as to when the undervaluation may correct itself. Over the years, this has been our largest category of investment, and more money has been made here than in either of the other categories. We usually have fairly large positions (5% to 10% of our total assets) in each of five or six generals, with smaller positions in another ten or fifteen.

Sometimes these work out very fast; many times they take years. It is difficult at the time of purchase to know any specific reason why they should appreciate in price. However, because of this lack of glamour or anything pending which

might create immediate favorable market action, they are available at very cheap prices. A lot of value can be obtained for the price paid. This substantial excess of value creates a comfortable margin of safety in each transaction. This individual margin of safety, coupled with a diversity of commitments creates a most attractive package of safety and appreciation potential. Over the years our timing of purchases has been considerably better than our timing of sales. We do not go into these generals with the idea of getting the last nickel, but are usually quite content selling out at some intermediate level between our purchase price and what we regard as fair value to a private owner.

The generals tend to behave market-wise very much in sympathy with the Dow. Just because something is cheap does not mean it is not going to go down. In times of abrupt downward movements in the market, this segment may very well go down percentage-wise just as much as the Dow. Over a period of years, I believe the generals will outperform the Dow, and during sharply advancing years like 1961, this is the section of our portfolio that turns in the best results. It is, of course, also the most vulnerable in a declining market.

Our second category consists of "work-outs." These are securities whose financial results depend on corporate action rather than supply and demand factors created by buyers and sellers of securities. In other words, they are securities with a timetable where we can predict, within reasonable error limits, when we will get how much and what might upset the applecart. Corporate events such as mergers, liquidations, reorganizations, spin-offs, etc. lead to work-outs. An important source in recent years has been sell-outs of oil producers to major integrated oil companies.

This category will produce reasonably stable earnings from year to year, to a large extent irrespective of the course of the Dow. Obviously, if we operate throughout a year with a large portion of our portfolio in work-outs, we will look extremely good if it turns out to be a declining year for the Dow or quite bad if it is a strongly advancing year. Over the years, work-outs have produced our second largest category. At any given time, we may be in ten to fifteen of these; some just beginning and others in the late stage of their development. We believe in using borrowed money to offset a portion of our work-out portfolio since there is a high degree of safety in this category in terms of both eventual results and intermediate market behavior. Results, excluding the benefits derived from the use of borrowed money, usually fall in the 10% to 20% range. My self-imposed limit regarding borrowing is 25% of partnership net worth. Oftentimes we owe no money and when we do borrow, it is only as an offset against work-outs.

The final category is "control" situations where we either control the company or take a very large position and attempt to influence policies of the company. Such operations should definitely be measured on the basis of several years. In a given year, they may produce nothing as it is usually to our advantage to let the stock be stagnant market-wise for a long period while we are acquiring. These situations, too, have relatively little in common with the behavior of the Dow. Sometimes, of course, we buy into a general with the thought in mind that it might develop into a control situation. If the price remains low enough

for a long period, this might very well happen. If it moves up before we have a substantial percentage of the company's stock, we sell at higher levels and complete a successful general operation. We are presently acquiring stock in what may turn out to be control situations several years hence.

### Dempster Mill Manufacturing Company

We are presently involved in the control of Dempster Mill Manufacturing Company of Beatrice, Nebraska. Our first stock was purchased as a generally undervalued security five years ago. A block later became available, and I went on the Board about four years ago. In August, 1961, we obtained majority control, which is indicative of the fact that many of our operations are not exactly of the "overnight" variety.

Presently we own 70% of the stock of Dempster with another 10% held by a few associates. With only 150 or so other stockholders, a market on the stock is virtually non-existent, and in any case, would have no meaning for a controlling block. Our own actions in such a market could drastically affect the quoted price.

Therefore, it is necessary for me to estimate the value at yearend of our controlling interest. This is of particular importance since, in effect, new partners are buying in based upon this price, and old partners are selling a portion of their interest based upon the same price. The estimated value should not be what we hope it would be worth, or what it might be worth to an eager buyer, etc., but what I would estimate our interest would bring if sold under current conditions in a reasonably short period of time. Our efforts will be devoted toward increasing this value, and we feel there are decent prospects of doing so.

Dempster is a manufacturer of farm implements and water systems with sales in 1961 of about \$9 million. Operations have produced only nominal profits in relation to invested capital during recent years. This reflected a poor management situation, along with a fairly tough industry situation. Presently, consolidated net worth (book value) is about \$4.5 million, or \$75 per share, consolidated working capital about \$50 per share, and at yearend we valued our interest at \$35 per share. While I claim no oracular vision in a matter such as this, I think this is a fair valuation to both new and old partners. Certainly, if even moderate earning power can be restored, a higher valuation will be justified, and even if it cannot, Dempster should work out at a higher figure. Our controlling interest was acquired at an average price of about \$28, and this holding currently represents 21% of partnership net assets based on the \$35 value.

Of course, this section of our portfolio is not going to be worth more money merely because General Motors, U. S. Steel, etc., sell higher. In a raging bull market, operations in control situations will seem like a very difficult way to make money, compared to just buying the general market. However, I am more conscious of the dangers presented at current market levels than the opportunities. Control situations, along with work-outs, provide a means of insulating a portion of our portfolio from these dangers.

## The Question of Conservatism

The above description of our various areas of operation may provide some clue as to how conservatively our portfolio is invested. Many people some years back thought they were behaving in the most conservative manner by purchasing medium or long-term municipal or government bonds. This policy has produced substantial market depreciation in many cases, and most certainly has failed to maintain or increase real buying power.

Conscious, perhaps overly conscious, of inflation, many people now feel that they are behaving in a conservative manner by buying blue chip securities all regardless of price-earnings ratios, dividend yields, etc. Without the benefit of hindsight as in the bond example, I feel this course of action is fraught with danger. There is nothing at all conservative, in my opinion, about speculating on just how high a multiplier a greedy and capricious public will put on earnings.

x You will not be right simply because a large number of people momentarily agree with you. You will not be right simply because important people agree with you. In many quarters the simultaneous occurrence of the two above factors is enough to make a course of action meet the test of conservatism.

You will be right, over the course of many transactions, if your hypotheses are correct, your facts are correct, and your reasoning is correct. True conservatism is only possible through knowledge and reason.

I might add that in no way does the fact that our portfolio is not conventional prove that we are more conservative or less conservative than standard methods of investing. This can only be determined by examining the methods or examining the results.

I feel the most objective test as to just how conservative our manner of investing arises through evaluation of performance in down markets. Preferably these should involve a substantial decline in the Dow. Our performance in the rather mild declines of 1957 and 1960 would confirm my hypothesis that we invest in an extremely conservative manner. I would welcome any partner's suggesting objective tests as to conservatism to see how we stack up. We have never suffered a realized loss of more than 1/2 of 1% of total net assets, and our ratio of total dollars of realized gains to total realized losses is something like 100 to 1. Of course, this reflects the fact that on balance we have been operating in an up market. However, there have been many opportunities for loss transactions even in markets such as these (you may have found out about a few of these yourselves) so I think the above facts have some significance.

## The Question of Size

Aside from the question as to what happens upon my death (which with a medical physical twist, is a subject of keen interest to me), I am probably asked most often: "What affect is the rapid growth of partnership funds going to have on performance?"

Larger funds tug in two directions. From the standpoint of "passive" investments, where we do not attempt by the size of our investment to influence corporate policies, larger sums hurt results. For the mutual fund or trust department investing in securities with very broad markets, the effect of large sums should be to penalize results only very slightly. Buying 10,000 shares of General Motors is only slightly more costly (on the basis of mathematical expectancy) than buying 1,000 or 100 shares.

In some of the securities in which we deal (but not all by any means) buying 10,000 shares is much more difficult than buying 100 and is sometimes impossible. Therefore, for a portion of our portfolio, larger sums are definitely disadvantageous. For a larger portion of the portfolio, I would say increased sums are only slightly disadvantageous. This category includes most of our work-outs and some generals.

However, in the case of control situations increased funds are a definite advantage. A "Sanborn Map" cannot be accomplished without the wherewithal. My definite belief is that the opportunities increase in this field as the funds increase. This is due to the sharp fall-off in competition as the ante mounts plus the important positive correlation that exists between increased size of company and lack of concentrated ownership of that company's stock.

Which is more important--the decreasing prospects of profitability in passive investments or the increasing prospects in control investments? I can't give a definite answer to this since to a great extent it depends on the type of market in which we are operating. My present opinion is that there is no reason to think these should not be offsetting factors; if my opinion should change, you will be told. I can say, most assuredly, that our results in 1960 and 1961 would not have been better if we had been operating with the much smaller sums of 1956 and 1957.

#### And a Prediction

Regular readers (I may be flattering myself) will feel I have left the tracks when I start talking about predictions. This is one thing from which I have always shied away and I still do in the normal sense.

I am certainly not going to predict what general business or the stock market are going to do in the next year or two since I don't have the faintest idea.

I think you can be quite sure that over the next ten years there are going to be a few years when the general market is plus 20% or 25%, a few when it is minus on the same order, and a majority when it is in between. I haven't any notion as to the sequence in which these will occur, nor do I think it is of any great importance for the long-term investor.

Over any long period of years, I think it likely that the Dow will probably produce something like 5% to 7% per year compounded from a combination of



dividends and market value gain. Despite the experience of recent years, anyone expecting substantially better than that from the general market probably faces disappointment.

Our job is to pile up yearly advantages over the performance of the Dow without worrying too much about whether the absolute results in a given year are a plus or a minus. I would consider a year in which we were down 15% and the Dow declined 25% to be much superior to a year when both the partnership and the Dow advanced 20%. I have stressed this point in talking with partners and have watched them nod their heads with varying degrees of enthusiasm. It is most important to me that you fully understand my reasoning in this regard and agree with me not only in your cerebral regions, but also down in the pit of your stomach.

For the reasons outlined in my method of operation, our best years relative to the Dow are likely to be in declining or static markets. Therefore, the advantage we seek will probably come in sharply varying amounts. There are bound to be years when we are surpassed by the Dow, but if over a long period we can average ten percentage points per year better than it, I will feel the result have been satisfactory.

Specifically, if the market should be down 35% or 40% in a year (and I feel this has a high probability of occurring one year in the next ten--no one knows which one), we should be down only 15% or 20%. If it is more or less unchanged during the year, we would hope to be up about ten percentage points. If it is up 20% or more, we would struggle to be up as much. The consequence of performance such as this over a period of years would mean that if the Dow produces a 5% to 7% per year over-all gain compounded, I would hope our results might be 15% to 17% per year.

The above expectations may sound somewhat rash, and there is no question but that they may appear very much so when viewed from the vantage point of 1961 or 1970. It may turn out that I am completely wrong. However, I feel the partners are certainly entitled to know what I am thinking in this regard even though the nature of the business is such as to introduce a high probability of error in such expectations. In any one year, the variations may be quite substantial. This happened in 1961, but fortunately the variation was on the pleasant side. They won't all be!

### Miscellaneous

We are now installed in an office at 810 Kiewit Plaza with a first-class secretary, Beth Henley, and an associate with considerable experience in my type of securities, Bill Scott. My father is sharing office space with us (he also shares the expenses) and doing a brokerage business in securities. None of our brokerage is done through him so we have no "vicuna coat" situation. Over-all, I expect our overhead, excluding interest on borrowings and Nebraska Intangibles Tax, to run less than .5 of 1% of net assets. We should get ou

money's worth from this expenditure, and you are most cordially invited to drop in and see how the money is being spent.

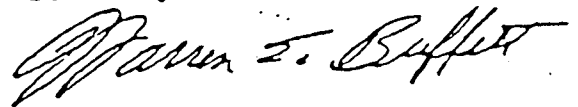
With over 80 partners and probably 40 or so securities, you can understand that it is quite a welcome relief to me to shake loose from some of the details.

We presently have partners residing in locations from California to Vermont, and net assets at the beginning of 1962 amounted to \$7,178,500.00. Susie and I have an interest in the partnership amounting to \$1,025,000.00, and other relatives of mine have a combined interest totaling \$782,600.00. The minimum for new partners last year was \$25,000, but I am giving some thought to increasing it this year.

Peat, Marwick, Mitchell & Company did an excellent job of expediting the audit providing tax figures much earlier than in the past. They assure me this performance can be continued.

Let me hear from you regarding questions you may have on any aspects of this letter, your audit, status of your partnership interest, etc., that may puzzle you.

Cordially,



Warren E. Buffett

WEB:bh  
Enc.

APPENDIX

Partnerships Operating Throughout 1961

<u>Partnership</u>	<u>1/1/61 Capital at Market</u>	<u>Over-all Gain in 1961 *</u>	<u>Percentage Gain</u>
Buffett Associates	\$ 486,874.27	\$ 225,387.80	46.3%
Buffett Fund	351,839.29	159,696.93	45.4
Dacee	235,480.31	116,504.47	49.5
Emdee	140,005.24	67,387.28	48.1
Glenoff	78,482.70	39,693.80	50.5
Mo-Buff	325,844.71	149,163.71	45.8
Underwood	<u>582,256.82</u>	<u>251,951.26</u>	<u>43.3</u>
	\$2,200,783.34	\$1,009,785.25	45.9%

Partnerships Started in 1961

<u>Partnership</u>	<u>Paid-in</u>	<u>Over-all Gain in 1961</u>	<u>Percentage Gain</u>
Ann Investments	\$ 100,100 (1-30-61)	\$ 35,367.93	35.3%
Buffett-TD	250,100 (\$200,100 on 3-8-61, \$50,000 on 5-31-61)	70,294.08	28.1
Buffett-Holland	125,100 (5-17-61)	16,703.76	13.3

\* Gain in net assets at market values plus payments to limited partners during year.