

## BERKSHIRE HATHAWAY INC.

### To the Shareholders of Berkshire Hathaway Inc.:

You may remember the wildly upbeat message of last year's report: nothing much was in the works but our experience had been that something big popped up occasionally. This carefully-crafted corporate strategy paid off in 1985. Later sections of this report discuss (a) our purchase of a major position in Capital Cities/ABC, (b) our acquisition of Scott & Fetzer, (c) our entry into a large, extended term participation in the insurance business of Fireman's Fund, and (d) our sale of our stock in General Foods.

Our gain in net worth during the year was \$613.6 million, or 48.2%. It is fitting that the visit of Halley's Comet coincided with this percentage gain: neither will be seen again in my lifetime. Our gain in per-share book value over the last twenty-one years (that is, since present management took over) has been from \$19.46 to \$1643.71, or 23.2% compounded annually, another percentage that will not be repeated.

Two factors make anything approaching this rate of gain unachievable in the future. One factor probably transitory - is a stock market that offers very little opportunity compared to the markets that prevailed throughout much of the 1964-1984 period. Today we cannot find significantly-undervalued equities to purchase for our insurance company portfolios. The current situation is 180 degrees removed from that existing about a decade ago, when the only question was which bargain to choose.

This change in the market also has negative implications for our present portfolio. In our 1974 annual report I could say: "We consider several of our major holdings to have great potential for significantly increased values in future years." I can't say that now. It's true that our insurance companies currently hold major positions in companies with exceptional underlying economics and outstanding managements, just as they did in 1974. But current market prices generously appraise these attributes, whereas they were ignored in 1974. Today's valuations mean that our insurance companies have no chance for future portfolio gains on the scale of those achieved in the past.

The second negative factor, far more telling, is our size. Our equity capital is more than twenty times what it was only ten years ago. And an iron law of business is that growth eventually dampens exceptional economics. Just look at the records of high-return companies once they have amassed even \$1 billion of equity capital. None that I know of has managed subsequently, over a ten-year period, to keep on earning 20% or more on equity while reinvesting all or substantially all of its earnings. Instead, to sustain their high returns, such companies have needed to shed a lot of capital by way of either dividends or repurchases of stock. Their shareholders would have been far better off if all earnings could have been reinvested at the fat returns earned by these exceptional businesses. But the companies simply couldn't turn up enough high-return opportunities to make that possible.

Their problem is our problem. Last year I told you that we needed profits of \$3.9 billion over the ten years then coming up to earn 15% annually. The comparable figure for the ten years now ahead is \$5.7 billion, a 48% increase that corresponds - as it must mathematically - to the growth in our capital base during 1985. (Here's a little perspective: leaving aside oil companies, only about 15 U.S. businesses have managed to earn over \$5.7

billion during the past ten years.)

Charlie Munger, my partner in managing Berkshire, and I are reasonably optimistic about Berkshire's ability to earn returns superior to those earned by corporate America generally, and you will benefit from the company's retention of all earnings as long as those returns are forthcoming. We have several things going for us: (1) we don't have to worry about quarterly or annual figures but, instead, can focus on whatever actions will maximize long-term value; (2) we can expand the business into any areas that make sense - our scope is not circumscribed by history, structure, or concept; and (3) we love our work. All of these help. Even so, we will also need a full measure of good fortune to average our hoped-for 15% - far more good fortune than was required for our past 23.2%.

We need to mention one further item in the investment equation that could affect recent purchasers of our stock. Historically, Berkshire shares have sold modestly below intrinsic business value. With the price there, purchasers could be certain (as long as they did not experience a widening of this discount) that their personal investment experience would at least equal the financial experience of the business. But recently the discount has disappeared, and occasionally a modest premium has prevailed.

The elimination of the discount means that Berkshire's market value increased even faster than business value (which, itself, grew at a pleasing pace). That was good news for any owner holding while that move took place, but it is bad news for the new or prospective owner. If the financial experience of new owners of Berkshire is merely to match the future financial experience of the company, any premium of market value over intrinsic business value that they pay must be maintained.

Management cannot determine market prices, although it can, by its disclosures and policies, encourage rational behavior by market participants. My own preference, as perhaps you'd guess, is for a market price that consistently approximates business value. Given that relationship, all owners prosper precisely as the business prospers during their period of ownership. Wild swings in market prices far above and below business value do not change the final gains for owners in aggregate; in the end, investor gains must equal business gains. But long periods of substantial undervaluation and/or overvaluation will cause the gains of the business to be inequitably distributed among various owners, with the investment result of any given owner largely depending upon how lucky, shrewd, or foolish he happens to be.

Over the long term there has been a more consistent relationship between Berkshire's market value and business value than has existed for any other publicly-traded equity with which I am familiar. This is a tribute to you. Because you have been rational, interested, and investment-oriented, the market price for Berkshire stock has almost always been sensible. This unusual result has been achieved by a shareholder group with unusual demographics: virtually all of our shareholders are individuals, not institutions. No other public company our size can claim the same.

You might think that institutions, with their large staffs of highly-paid and experienced investment professionals, would be a force for stability and reason in financial markets. They are not: stocks heavily owned and constantly monitored by institutions have often been among the most inappropriately valued.

Ben Graham told a story 40 years ago that illustrates why investment professionals behave as they do: An oil prospector,

moving to his heavenly reward, was met by St. Peter with bad news. "You're qualified for residence", said St. Peter, "but, as you can see, the compound reserved for oil men is packed. There's no way to squeeze you in." After thinking a moment, the prospector asked if he might say just four words to the present occupants. That seemed harmless to St. Peter, so the prospector cupped his hands and yelled, "Oil discovered in hell." Immediately the gate to the compound opened and all of the oil men marched out to head for the nether regions. Impressed, St. Peter invited the prospector to move in and make himself comfortable. The prospector paused. "No," he said, "I think I'll go along with the rest of the boys. There might be some truth to that rumor after all."

## Sources of Reported Earnings

The table on the next page shows the major sources of Berkshire's reported earnings. These numbers, along with far more detailed sub-segment numbers, are the ones that Charlie and I focus upon. We do not find consolidated figures an aid in either managing or evaluating Berkshire and, in fact, never prepare them for internal use.

Segment information is equally essential for investors wanting to know what is going on in a multi-line business. Corporate managers always have insisted upon such information before making acquisition decisions but, until a few years ago, seldom made it available to investors faced with acquisition and disposition decisions of their own. Instead, when owners wishing to understand the economic realities of their business asked for data, managers usually gave them a we-can't-tell-you-what-is-going-on-because-it-would-hurt-the-company answer. Ultimately the SEC ordered disclosure of segment data and management began supplying real answers. The change in their behavior recalls an insight of Al Capone: "You can get much further with a kind word and a gun than you can with a kind word alone."

In the table, amortization of Goodwill is not charged against the specific businesses but, for reasons outlined in the Appendix to my letter in the 1983 annual report, is aggregated as a separate item. (A compendium of the 1977-1984 letters is available upon request.) In the Business Segment Data and Management's Discussion sections on pages 39-41 and 49-55, much additional information regarding our businesses is provided, including Goodwill and Goodwill Amortization figures for each of the segments. I urge you to read those sections as well as Charlie Munger's letter to Wesco shareholders, which starts on page 56.

(000s omitted)

	<i>Pre-Tax Earnings</i>		<i>Berkshire's Share of Net Earnings (after taxes and minority interests)</i>	
	<i>1985</i>	<i>1984</i>	<i>1985</i>	<i>1984</i>
Operating Earnings:				
Insurance Group:				
Underwriting .....	\$(44,230)	\$(48,060)	\$(23,569)	\$(25,955)
Net Investment Income .....	95,217	68,903	79,716	62,059
Associated Retail Stores .....	270	(1,072)	134	(579)
Blue Chip Stamps .....	5,763	(1,843)	2,813	(899)
Buffalo News .....	29,921	27,328	14,580	13,317
Mutual Savings and Loan .....	2,622	1,456	4,016	3,151
Nebraska Furniture Mart .....	12,686	14,511	5,181	5,917
Precision Steel .....	3,896	4,092	1,477	1,696
See's Candies .....	28,989	26,644	14,558	13,380
Textiles .....	(2,395)	418	(1,324)	226

Wesco Financial .....	9,500	9,777	4,191	4,828
Amortization of Goodwill .....	(1,475)	(1,434)	(1,475)	(1,434)
Interest on Debt .....	(14,415)	(14,734)	(7,288)	(7,452)
Shareholder-Designated				
Contributions .....	(4,006)	(3,179)	(2,164)	(1,716)
Other .....	3,106	4,932	2,102	3,475
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Operating Earnings .....	125,449	87,739	92,948	70,014
Special General Foods Distribution	4,127	8,111	3,779	7,294
Special Washington Post				
Distribution .....	14,877	---	13,851	---
Sales of Securities .....	468,903	104,699	325,237	71,587
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Total Earnings - all entities ...	\$613,356	\$200,549	\$435,815	\$148,895
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Our 1985 results include unusually large earnings from the sale of securities. This fact, in itself, does not mean that we had a particularly good year (though, of course, we did). Security profits in a given year bear similarities to a college graduation ceremony in which the knowledge gained over four years is recognized on a day when nothing further is learned. We may hold a stock for a decade or more, and during that period it may grow quite consistently in both business and market value. In the year in which we finally sell it there may be no increase in value, or there may even be a decrease. But all growth in value since purchase will be reflected in the accounting earnings of the year of sale. (If the stock owned is in our insurance subsidiaries, however, any gain or loss in market value will be reflected in net worth annually.) Thus, reported capital gains or losses in any given year are meaningless as a measure of how well we have done in the current year.

A large portion of the realized gain in 1985 (\$338 million pre-tax out of a total of \$488 million) came about through the sale of our General Foods shares. We held most of these shares since 1980, when we had purchased them at a price far below what we felt was their per/share business value. Year by year, the managerial efforts of Jim Ferguson and Phil Smith substantially increased General Foods' business value and, last fall, Philip Morris made an offer for the company that reflected the increase. We thus benefited from four factors: a bargain purchase price, a business with fine underlying economics, an able management concentrating on the interests of shareholders, and a buyer willing to pay full business value. While that last factor is the only one that produces reported earnings, we consider identification of the first three to be the key to building value for Berkshire shareholders. In selecting common stocks, we devote our attention to attractive purchases, not to the possibility of attractive sales.

We have again reported substantial income from special distributions, this year from Washington Post and General Foods. (The General Foods transactions obviously took place well before the Philip Morris offer.) Distributions of this kind occur when we sell a portion of our shares in a company back to it simultaneously with its purchase of shares from other shareholders. The number of shares we sell is contractually set so as to leave our percentage ownership in the company precisely the same after the sale as before. Such a transaction is quite properly regarded by the IRS as substantially equivalent to a dividend since we, as a shareholder, receive cash while maintaining an unchanged ownership interest. This tax treatment benefits us because corporate taxpayers, unlike individual taxpayers, incur much lower taxes on dividend income than on income from long-term capital gains. (This difference will be widened further if the House-passed tax bill becomes law: under its provisions, capital gains realized by corporations will be taxed at the same rate as ordinary income.) However, accounting

rules are unclear as to proper treatment for shareholder reporting. To conform with last year's treatment, we have shown these transactions as capital gains.

Though we have not sought out such transactions, we have agreed to them on several occasions when managements initiated the idea. In each case we have felt that non-selling shareholders (all of whom had an opportunity to sell at the same price we received) benefited because the companies made their repurchases at prices below intrinsic business value. The tax advantages we receive and our wish to cooperate with managements that are increasing values for all shareholders have sometimes led us to sell - but only to the extent that our proportional share of the business was undiminished.

At this point we usually turn to a discussion of some of our major business units. Before doing so, however, we should first look at a failure at one of our smaller businesses. Our Vice Chairman, Charlie Munger, has always emphasized the study of mistakes rather than successes, both in business and other aspects of life. He does so in the spirit of the man who said: "All I want to know is where I'm going to die so I'll never go there." You'll immediately see why we make a good team: Charlie likes to study errors and I have generated ample material for him, particularly in our textile and insurance businesses.

### **Shutdown of Textile Business**

In July we decided to close our textile operation, and by yearend this unpleasant job was largely completed. The history of this business is instructive.

When Buffett Partnership, Ltd., an investment partnership of which I was general partner, bought control of Berkshire Hathaway 21 years ago, it had an accounting net worth of \$22 million, all devoted to the textile business. The company's intrinsic business value, however, was considerably less because the textile assets were unable to earn returns commensurate with their accounting value. Indeed, during the previous nine years (the period in which Berkshire and Hathaway operated as a merged company) aggregate sales of \$530 million had produced an aggregate loss of \$10 million. Profits had been reported from time to time but the net effect was always one step forward, two steps back.

At the time we made our purchase, southern textile plants - largely non-union - were believed to have an important competitive advantage. Most northern textile operations had closed and many people thought we would liquidate our business as well.

We felt, however, that the business would be run much better by a long-time employee whom we immediately selected to be president, Ken Chace. In this respect we were 100% correct: Ken and his recent successor, Garry Morrison, have been excellent managers, every bit the equal of managers at our more profitable businesses.

In early 1967 cash generated by the textile operation was used to fund our entry into insurance via the purchase of National Indemnity Company. Some of the money came from earnings and some from reduced investment in textile inventories, receivables, and fixed assets. This pullback proved wise: although much improved by Ken's management, the textile business never became a good earner, not even in cyclical upturns.

Further diversification for Berkshire followed, and gradually the textile operation's depressing effect on our overall return diminished as the business became a progressively

smaller portion of the corporation. We remained in the business for reasons that I stated in the 1978 annual report (and summarized at other times also): "(1) our textile businesses are very important employers in their communities, (2) management has been straightforward in reporting on problems and energetic in attacking them, (3) labor has been cooperative and understanding in facing our common problems, and (4) the business should average modest cash returns relative to investment." I further said, "As long as these conditions prevail - and we expect that they will - we intend to continue to support our textile business despite more attractive alternative uses for capital."

It turned out that I was very wrong about (4). Though 1979 was moderately profitable, the business thereafter consumed major amounts of cash. By mid-1985 it became clear, even to me, that this condition was almost sure to continue. Could we have found a buyer who would continue operations, I would have certainly preferred to sell the business rather than liquidate it, even if that meant somewhat lower proceeds for us. But the economics that were finally obvious to me were also obvious to others, and interest was nil.

I won't close down businesses of sub-normal profitability merely to add a fraction of a point to our corporate rate of return. However, I also feel it inappropriate for even an exceptionally profitable company to fund an operation once it appears to have unending losses in prospect. Adam Smith would disagree with my first proposition, and Karl Marx would disagree with my second; the middle ground is the only position that leaves me comfortable.

I should reemphasize that Ken and Garry have been resourceful, energetic and imaginative in attempting to make our textile operation a success. Trying to achieve sustainable profitability, they reworked product lines, machinery configurations and distribution arrangements. We also made a major acquisition, Waumbec Mills, with the expectation of important synergy (a term widely used in business to explain an acquisition that otherwise makes no sense). But in the end nothing worked and I should be faulted for not quitting sooner. A recent *Business Week* article stated that 250 textile mills have closed since 1980. Their owners were not privy to any information that was unknown to me; they simply processed it more objectively. I ignored Comte's advice - "the intellect should be the servant of the heart, but not its slave" - and believed what I preferred to believe.

The domestic textile industry operates in a commodity business, competing in a world market in which substantial excess capacity exists. Much of the trouble we experienced was attributable, both directly and indirectly, to competition from foreign countries whose workers are paid a small fraction of the U.S. minimum wage. But that in no way means that our labor force deserves any blame for our closing. In fact, in comparison with employees of American industry generally, our workers were poorly paid, as has been the case throughout the textile business. In contract negotiations, union leaders and members were sensitive to our disadvantageous cost position and did not push for unrealistic wage increases or unproductive work practices. To the contrary, they tried just as hard as we did to keep us competitive. Even during our liquidation period they performed superbly. (Ironically, we would have been better off financially if our union had behaved unreasonably some years ago; we then would have recognized the impossible future that we faced, promptly closed down, and avoided significant future losses.)

Over the years, we had the option of making large capital expenditures in the textile operation that would have allowed us to somewhat reduce variable costs. Each proposal to do so looked

like an immediate winner. Measured by standard return-on-investment tests, in fact, these proposals usually promised greater economic benefits than would have resulted from comparable expenditures in our highly-profitable candy and newspaper businesses.

But the promised benefits from these textile investments were illusory. Many of our competitors, both domestic and foreign, were stepping up to the same kind of expenditures and, once enough companies did so, their reduced costs became the baseline for reduced prices industrywide. Viewed individually, each company's capital investment decision appeared cost-effective and rational; viewed collectively, the decisions neutralized each other and were irrational (just as happens when each person watching a parade decides he can see a little better if he stands on tiptoes). After each round of investment, all the players had more money in the game and returns remained anemic.

Thus, we faced a miserable choice: huge capital investment would have helped to keep our textile business alive, but would have left us with terrible returns on ever-growing amounts of capital. After the investment, moreover, the foreign competition would still have retained a major, continuing advantage in labor costs. A refusal to invest, however, would make us increasingly non-competitive, even measured against domestic textile manufacturers. I always thought myself in the position described by Woody Allen in one of his movies: "More than any other time in history, mankind faces a crossroads. One path leads to despair and utter hopelessness, the other to total extinction. Let us pray we have the wisdom to choose correctly."

For an understanding of how the to-invest-or-not-to-invest dilemma plays out in a commodity business, it is instructive to look at Burlington Industries, by far the largest U.S. textile company both 21 years ago and now. In 1964 Burlington had sales of \$1.2 billion against our \$50 million. It had strengths in both distribution and production that we could never hope to match and also, of course, had an earnings record far superior to ours. Its stock sold at 60 at the end of 1964; ours was 13.

Burlington made a decision to stick to the textile business, and in 1985 had sales of about \$2.8 billion. During the 1964-85 period, the company made capital expenditures of about \$3 billion, far more than any other U.S. textile company and more than \$200-per-share on that \$60 stock. A very large part of the expenditures, I am sure, was devoted to cost improvement and expansion. Given Burlington's basic commitment to stay in textiles, I would also surmise that the company's capital decisions were quite rational.

Nevertheless, Burlington has lost sales volume in real dollars and has far lower returns on sales and equity now than 20 years ago. Split 2-for-1 in 1965, the stock now sells at 34 -- on an adjusted basis, just a little over its \$60 price in 1964. Meanwhile, the CPI has more than tripled. Therefore, each share commands about one-third the purchasing power it did at the end of 1964. Regular dividends have been paid but they, too, have shrunk significantly in purchasing power.

This devastating outcome for the shareholders indicates what can happen when much brain power and energy are applied to a faulty premise. The situation is suggestive of Samuel Johnson's horse: "A horse that can count to ten is a remarkable horse - not a remarkable mathematician." Likewise, a textile company that allocates capital brilliantly within its industry is a remarkable textile company - but not a remarkable business.

My conclusion from my own experiences and from much

observation of other businesses is that a good managerial record (measured by economic returns) is far more a function of what business boat you get into than it is of how effectively you row (though intelligence and effort help considerably, of course, in any business, good or bad). Some years ago I wrote: "When a management 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." Nothing has since changed my point of view on that matter. Should you find yourself in a chronically-leaking boat, energy devoted to changing vessels is likely to be more productive than energy devoted to patching leaks.

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There is an investment postscript in our textile saga. Some investors weight book value heavily in their stock-buying decisions (as I, in my early years, did myself). And some economists and academicians believe replacement values are of considerable importance in calculating an appropriate price level for the stock market as a whole. Those of both persuasions would have received an education at the auction we held in early 1986 to dispose of our textile machinery.

The equipment sold (including some disposed of in the few months prior to the auction) took up about 750,000 square feet of factory space in New Bedford and was eminently usable. It originally cost us about \$13 million, including \$2 million spent in 1980-84, and had a current book value of \$866,000 (after accelerated depreciation). Though no sane management would have made the investment, the equipment could have been replaced new for perhaps \$30-\$50 million.

Gross proceeds from our sale of this equipment came to \$163,122. Allowing for necessary pre- and post-sale costs, our net was less than zero. Relatively modern looms that we bought for \$5,000 apiece in 1981 found no takers at \$50. We finally sold them for scrap at \$26 each, a sum less than removal costs.

Ponder this: the economic goodwill attributable to two paper routes in Buffalo - or a single See's candy store - considerably exceeds the proceeds we received from this massive collection of tangible assets that not too many years ago, under different competitive conditions, was able to employ over 1,000 people.

### **Three Very Good Businesses (and a Few Thoughts About Incentive Compensation)**

When I was 12, I lived with my grandfather for about four months. A grocer by trade, he was also working on a book and each night he dictated a few pages to me. The title - brace yourself - was "How to Run a Grocery Store and a Few Things I Have Learned About Fishing". My grandfather was sure that interest in these two subjects was universal and that the world awaited his views. You may conclude from this section's title and contents that I was overexposed to Grandpa's literary style (and personality).

I am merging the discussion of Nebraska Furniture Mart, See's Candy Shops, and Buffalo Evening News here because the economic strengths, weaknesses, and prospects of these businesses have changed little since I reported to you a year ago. The shortness of this discussion, however, is in no way meant to minimize the importance of these businesses to us: in 1985 they earned an aggregate of \$72 million pre-tax. Fifteen years ago, before we had acquired any of them, their aggregate earnings were about \$8 million pre-tax.

While an increase in earnings from \$8 million to \$72 million



sounds terrific - and usually is - you should not automatically assume that to be the case. You must first make sure that earnings were not severely depressed in the base year. If they were instead substantial in relation to capital employed, an even more important point must be examined: how much additional capital was required to produce the additional earnings?

In both respects, our group of three scores well. First, earnings 15 years ago were excellent compared to capital then employed in the businesses. Second, although annual earnings are now \$64 million greater, the businesses require only about \$40 million more in invested capital to operate than was the case then.

The dramatic growth in earning power of these three businesses, accompanied by their need for only minor amounts of capital, illustrates very well the power of economic goodwill during an inflationary period (a phenomenon explained in detail in the 1983 annual report). The financial characteristics of these businesses have allowed us to use a very large portion of the earnings they generate elsewhere. Corporate America, however, has had a different experience: in order to increase earnings significantly, most companies have needed to increase capital significantly also. The average American business has required about \$5 of additional capital to generate an additional \$1 of annual pre-tax earnings. That business, therefore, would have required over \$300 million in additional capital from its owners in order to achieve an earnings performance equal to our group of three.

When returns on capital are ordinary, an earn-more-by-putting-up-more record is no great managerial achievement. You can get the same result personally while operating from your rocking chair. Just quadruple the capital you commit to a savings account and you will quadruple your earnings. You would hardly expect hosannas for that particular accomplishment. Yet, retirement announcements regularly sing the praises of CEOs who have, say, quadrupled earnings of their widget company during their reign - with no one examining whether this gain was attributable simply to many years of retained earnings and the workings of compound interest.

If the widget company consistently earned a superior return on capital throughout the period, or if capital employed only doubled during the CEO's reign, the praise for him may be well deserved. But if return on capital was lackluster and capital employed increased in pace with earnings, applause should be withheld. A savings account in which interest was reinvested would achieve the same year-by-year increase in earnings - and, at only 8% interest, would quadruple its annual earnings in 18 years.

The power of this simple math is often ignored by companies to the detriment of their shareholders. Many corporate compensation plans reward managers handsomely for earnings increases produced solely, or in large part, by retained earnings - i.e., earnings withheld from owners. For example, ten-year, fixed-price stock options are granted routinely, often by companies whose dividends are only a small percentage of earnings.

An example will illustrate the inequities possible under such circumstances. Let's suppose that you had a \$100,000 savings account earning 8% interest and "managed" by a trustee who could decide each year what portion of the interest you were to be paid in cash. Interest not paid out would be "retained earnings" added to the savings account to compound. And let's suppose that your trustee, in his superior wisdom, set the "pay-out ratio" at one-quarter of the annual earnings.

Under these assumptions, your account would be worth \$179,084 at the end of ten years. Additionally, your annual earnings would have increased about 70% from \$8,000 to \$13,515 under this inspired management. And, finally, your "dividends" would have increased commensurately, rising regularly from \$2,000 in the first year to \$3,378 in the tenth year. Each year, when your manager's public relations firm prepared his annual report to you, all of the charts would have had lines marching skyward.

Now, just for fun, let's push our scenario one notch further and give your trustee-manager a ten-year fixed-price option on part of your "business" (i.e., your savings account) based on its fair value in the first year. With such an option, your manager would reap a substantial profit at your expense - just from having held on to most of your earnings. If he were both Machiavellian and a bit of a mathematician, your manager might also have cut the pay-out ratio once he was firmly entrenched.

This scenario is not as farfetched as you might think. Many stock options in the corporate world have worked in exactly that fashion: they have gained in value simply because management retained earnings, not because it did well with the capital in its hands.

Managers actually apply a double standard to options. Leaving aside warrants (which deliver the issuing corporation immediate and substantial compensation), I believe it is fair to say that nowhere in the business world are ten-year fixed-price options on all or a portion of a business granted to outsiders. Ten months, in fact, would be regarded as extreme. It would be particularly unthinkable for managers to grant a long-term option on a business that was regularly adding to its capital. Any outsider wanting to secure such an option would be required to pay fully for capital added during the option period.

The unwillingness of managers to do-unto-outsidere, however, is not matched by an unwillingness to do-unto-themselves. (Negotiating with one's self seldom produces a barroom brawl.) Managers regularly engineer ten-year, fixed-price options for themselves and associates that, first, totally ignore the fact that retained earnings automatically build value and, second, ignore the carrying cost of capital. As a result, these managers end up profiting much as they would have had they had an option on that savings account that was automatically building up in value.

Of course, stock options often go to talented, value-adding managers and sometimes deliver them rewards that are perfectly appropriate. (Indeed, managers who are really exceptional almost always get far less than they should.) But when the result is equitable, it is accidental. Once granted, the option is blind to individual performance. Because it is irrevocable and unconditional (so long as a manager stays in the company), the sluggard receives rewards from his options precisely as does the star. A managerial Rip Van Winkle, ready to doze for ten years, could not wish for a better "incentive" system.

(I can't resist commenting on one long-term option given an "outsider": that granted the U.S. Government on Chrysler shares as partial consideration for the government's guarantee of some lifesaving loans. When these options worked out well for the government, Chrysler sought to modify the payoff, arguing that the rewards to the government were both far greater than intended and outsize in relation to its contribution to Chrysler's recovery. The company's anguish over what it saw as an imbalance between payoff and performance made national news. That anguish may well be unique: to my knowledge, no managers - anywhere - have been similarly offended by unwarranted payoffs arising from

options granted to themselves or their colleagues.)

Ironically, the rhetoric about options frequently describes them as desirable because they put managers and owners in the same financial boat. In reality, the boats are far different. No owner has ever escaped the burden of capital costs, whereas a holder of a fixed-price option bears no capital costs at all. An owner must weigh upside potential against downside risk; an option holder has no downside. In fact, the business project in which you would wish to have an option frequently is a project in which you would reject ownership. (I'll be happy to accept a lottery ticket as a gift - but I'll never buy one.)

In dividend policy also, the option holders' interests are best served by a policy that may ill serve the owner. Think back to the savings account example. The trustee, holding his option, would benefit from a no-dividend policy. Conversely, the owner of the account should lean to a total payout so that he can prevent the option-holding manager from sharing in the account's retained earnings.

Despite their shortcomings, options can be appropriate under some circumstances. My criticism relates to their indiscriminate use and, in that connection, I would like to emphasize three points:

First, stock options are inevitably tied to the overall performance of a corporation. Logically, therefore, they should be awarded only to those managers with overall responsibility. Managers with limited areas of responsibility should have incentives that pay off in relation to results under their control. The .350 hitter expects, and also deserves, a big payoff for his performance - even if he plays for a cellar-dwelling team. And the .150 hitter should get no reward - even if he plays for a pennant winner. Only those with overall responsibility for the team should have their rewards tied to its results.

Second, options should be structured carefully. Absent special factors, they should have built into them a retained-earnings or carrying-cost factor. Equally important, they should be priced realistically. When managers are faced with offers for their companies, they unflinchingly point out how unrealistic market prices can be as an index of real value. But why, then, should these same depressed prices be the valuations at which managers sell portions of their businesses to themselves? (They may go further: officers and directors sometimes consult the Tax Code to determine the lowest prices at which they can, in effect, sell part of the business to insiders. While they're at it, they often elect plans that produce the worst tax result for the company.) Except in highly unusual cases, owners are not well served by the sale of part of their business at a bargain price - whether the sale is to outsiders or to insiders. The obvious conclusion: options should be priced at true business value.

Third, I want to emphasize that some managers whom I admire enormously - and whose operating records are far better than mine - disagree with me regarding fixed-price options. They have built corporate cultures that work, and fixed-price options have been a tool that helped them. By their leadership and example, and by the use of options as incentives, these managers have taught their colleagues to think like owners. Such a Culture is rare and when it exists should perhaps be left intact - despite inefficiencies and inequities that may infest the option program. "If it ain't broke, don't fix it" is preferable to "purity at any price".

At Berkshire, however, we use an incentive@compensation system that rewards key managers for meeting targets in their own

bailiwicks. If See's does well, that does not produce incentive compensation at the News - nor vice versa. Neither do we look at the price of Berkshire stock when we write bonus checks. We believe good unit performance should be rewarded whether Berkshire stock rises, falls, or stays even. Similarly, we think average performance should earn no special rewards even if our stock should soar. "Performance", furthermore, is defined in different ways depending upon the underlying economics of the business: in some our managers enjoy tailwinds not of their own making, in others they fight unavoidable headwinds.

The rewards that go with this system can be large. At our various business units, top managers sometimes receive incentive bonuses of five times their base salary, or more, and it would appear possible that one manager's bonus could top \$2 million in 1986. (I hope so.) We do not put a cap on bonuses, and the potential for rewards is not hierarchical. The manager of a relatively small unit can earn far more than the manager of a larger unit if results indicate he should. We believe, further, that such factors as seniority and age should not affect incentive compensation (though they sometimes influence basic compensation). A 20-year-old who can hit .300 is as valuable to us as a 40-year-old performing as well.

Obviously, all Berkshire managers can use their bonus money (or other funds, including borrowed money) to buy our stock in the market. Many have done just that - and some now have large holdings. By accepting both the risks and the carrying costs that go with outright purchases, these managers truly walk in the shoes of owners.

Now let's get back - at long last - to our three businesses:

At Nebraska Furniture Mart our basic strength is an exceptionally low-cost operation that allows the business to regularly offer customers the best values available in home furnishings. NFM is the largest store of its kind in the country. Although the already-depressed farm economy worsened considerably in 1985, the store easily set a new sales record. I also am happy to report that NFM's Chairman, Rose Blumkin (the legendary "Mrs. B"), continues at age 92 to set a pace at the store that none of us can keep up with. She's there wheeling and dealing seven days a week, and I hope that any of you who visit Omaha will go out to the Mart and see her in action. It will inspire you, as it does me.

At See's we continue to get store volumes that are far beyond those achieved by any competitor we know of. Despite the unmatched consumer acceptance we enjoy, industry trends are not good, and we continue to experience slippage in poundage sales on a same-store basis. This puts pressure on per-pound costs. We now are willing to increase prices only modestly and, unless we can stabilize per-shop poundage, profit margins will narrow.

At the News volume gains are also difficult to achieve. Though lineage increased during 1985, the gain was more than accounted for by preprints. ROP lineage (advertising printed on our own pages) declined. Preprints are far less profitable than ROP ads, and also more vulnerable to competition. In 1985, the News again controlled costs well and our household penetration continues to be exceptional.

One problem these three operations do not have is management. At See's we have Chuck Huggins, the man we put in charge the day we bought the business. Selecting him remains one of our best business decisions. At the News we have Stan Lipsey, a manager of equal caliber. Stan has been with us 17 years, and his unusual business talents have become more evident with every additional level of responsibility he has tackled. And, at the

Mart, we have the amazing Blumkins - Mrs. B, Louie, Ron, Irv, and Steve - a three-generation miracle of management.

I consider myself extraordinarily lucky to be able to work with managers such as these. I like them personally as much as I admire them professionally.

### Insurance Operations

Shown below is an updated version of our usual table, listing two key figures for the insurance industry:

	<i>Yearly Change in Premiums Written (%)</i>	<i>Combined Ratio after Policyholder Dividends</i>
	-----	-----
1972 .....	10.2	96.2
1973 .....	8.0	99.2
1974 .....	6.2	105.4
1975 .....	11.0	107.9
1976 .....	21.9	102.4
1977 .....	19.8	97.2
1978 .....	12.8	97.5
1979 .....	10.3	100.6
1980 .....	6.0	103.1
1981 .....	3.9	106.0
1982 .....	4.4	109.7
1983 .....	4.5	111.9
1984 (Revised) .....	9.2	117.9
1985 (Estimated) ...	20.9	118.0

Source: Best's Aggregates and Averages

The combined ratio represents total insurance costs (losses incurred plus expenses) compared to revenue from premiums: a ratio below 100 indicates an underwriting profit, and one above 100 indicates a loss.

The industry's 1985 results were highly unusual. The revenue gain was exceptional, and had insured losses grown at their normal rate of most recent years - that is, a few points above the inflation rate - a significant drop in the combined ratio would have occurred. But losses in 1985 didn't cooperate, as they did not in 1984. Though inflation slowed considerably in these years, insured losses perversely accelerated, growing by 16% in 1984 and by an even more startling 17% in 1985. The year's growth in losses therefore exceeds the inflation rate by over 13 percentage points, a modern record.

Catastrophes were not the culprit in this explosion of loss cost. True, there were an unusual number of hurricanes in 1985, but the aggregate damage caused by all catastrophes in 1984 and 1985 was about 2% of premium volume, a not unusual proportion. Nor was there any burst in the number of insured autos, houses, employers, or other kinds of "exposure units".

A partial explanation for the surge in the loss figures is all the additions to reserves that the industry made in 1985. As results for the year were reported, the scene resembled a revival meeting: shouting "I've sinned, I've sinned", insurance managers rushed forward to confess they had under reserved in earlier years. Their corrections significantly affected 1985 loss numbers.

A more disturbing ingredient in the loss surge is the acceleration in "social" or "judicial" inflation. The insurer's ability to pay has assumed overwhelming importance with juries and judges in the assessment of both liability and damages. More and more, "the deep pocket" is being sought and found, no matter

what the policy wording, the facts, or the precedents.

This judicial inflation represents a wild card in the industry's future, and makes forecasting difficult. Nevertheless, the short-term outlook is good. Premium growth improved as 1985 went along (quarterly gains were an estimated 15%, 19%, 24%, and 22%) and, barring a supercatastrophe, the industry's combined ratio should fall sharply in 1986.

The profit improvement, however, is likely to be of short duration. Two economic principles will see to that. First, commodity businesses achieve good levels of profitability only when prices are fixed in some manner or when capacity is short. Second, managers quickly add to capacity when prospects start to improve and capital is available.

In my 1982 report to you, I discussed the commodity nature of the insurance industry extensively. The typical policyholder does not differentiate between products but concentrates instead on price. For many decades a cartel-like procedure kept prices up, but this arrangement has disappeared for good. The insurance product now is priced as any other commodity for which a free market exists: when capacity is tight, prices will be set remuneratively; otherwise, they will not be.

Capacity currently is tight in many lines of insurance - though in this industry, unlike most, capacity is an attitudinal concept, not a physical fact. Insurance managers can write whatever amount of business they feel comfortable writing, subject only to pressures applied by regulators and Best's, the industry's authoritative rating service. The comfort level of both managers and regulators is tied to capital. More capital means more comfort, which in turn means more capacity. In the typical commodity business, furthermore, such as aluminum or steel, a long gestation precedes the birth of additional capacity. In the insurance industry, capital can be secured instantly. Thus, any capacity shortage can be eliminated in short order.

That's exactly what's going on right now. In 1985, about 15 insurers raised well over \$3 billion, piling up capital so that they can write all the business possible at the better prices now available. The capital-raising trend has accelerated dramatically so far in 1986.

If capacity additions continue at this rate, it won't be long before serious price-cutting appears and next a fall in profitability. When the fall comes, it will be the fault of the capital-raisers of 1985 and 1986, not the price-cutters of 198X. (Critics should be understanding, however: as was the case in our textile example, the dynamics of capitalism cause each insurer to make decisions that for itself appear sensible, but that collectively slash profitability.)

In past reports, I have told you that Berkshire's strong capital position - the best in the industry - should one day allow us to claim a distinct competitive advantage in the insurance market. With the tightening of the market, that day arrived. Our premium volume more than tripled last year, following a long period of stagnation. Berkshire's financial strength (and our record of maintaining unusual strength through thick and thin) is now a major asset for us in securing good business.

We correctly foresaw a flight to quality by many large buyers of insurance and reinsurance who belatedly recognized that a policy is only an IOU - and who, in 1985, could not collect on many of their IOUs. These buyers today are attracted to Berkshire because of its strong capital position. But, in a

development we did not foresee, we also are finding buyers drawn to us because our ability to insure substantial risks sets us apart from the crowd.

To understand this point, you need a few background facts about large risks. Traditionally, many insurers have wanted to write this kind of business. However, their willingness to do so has been almost always based upon reinsurance arrangements that allow the insurer to keep just a small portion of the risk itself while passing on ("laying off") most of the risk to its reinsurers. Imagine, for example, a directors and officers ("D & O") liability policy providing \$25 million of coverage. By various "excess-of-loss" reinsurance contracts, the company issuing that policy might keep the liability for only the first \$1 million of any loss that occurs. The liability for any loss above that amount up to \$24 million would be borne by the reinsurers of the issuing insurer. In trade parlance, a company that issues large policies but retains relatively little of the risk for its own account writes a large gross line but a small net line.

In any reinsurance arrangement, a key question is how the premiums paid for the policy should be divided among the various "layers" of risk. In our D & O policy, for example, what part of the premium received should be kept by the issuing company to compensate it fairly for taking the first \$1 million of risk and how much should be passed on to the reinsurers to compensate them fairly for taking the risk between \$1 million and \$25 million?

One way to solve this problem might be deemed the Patrick Henry approach: "I have but one lamp by which my feet are guided, and that is the lamp of experience." In other words, how much of the total premium would reinsurers have needed in the past to compensate them fairly for the losses they actually had to bear?

Unfortunately, the lamp of experience has always provided imperfect illumination for reinsurers because so much of their business is "long-tail", meaning it takes many years before they know what their losses are. Lately, however, the light has not only been dim but also grossly misleading in the images it has revealed. That is, the courts' tendency to grant awards that are both huge and lacking in precedent makes reinsurers' usual extrapolations or inferences from past data a formula for disaster. Out with Patrick Henry and in with Pogo: "The future ain't what it used to be."

The burgeoning uncertainties of the business, coupled with the entry into reinsurance of many unsophisticated participants, worked in recent years in favor of issuing companies writing a small net line: they were able to keep a far greater percentage of the premiums than the risk. By doing so, the issuing companies sometimes made money on business that was distinctly unprofitable for the issuing and reinsuring companies combined. (This result was not necessarily by intent: issuing companies generally knew no more than reinsurers did about the ultimate costs that would be experienced at higher layers of risk.) Inequities of this sort have been particularly pronounced in lines of insurance in which much change was occurring and losses were soaring; e.g., professional malpractice, D & O, products liability, etc. Given these circumstances, it is not surprising that issuing companies remained enthusiastic about writing business long after premiums became woefully inadequate on a gross basis.

An example of just how disparate results have been for issuing companies versus their reinsurers is provided by the 1984 financials of one of the leaders in large and unusual risks. In that year the company wrote about \$6 billion of business and kept around \$2 1/2 billion of the premiums, or about 40%. It gave the

remaining \$3 1/2 billion to reinsurers. On the part of the business kept, the company's underwriting loss was less than \$200 million - an excellent result in that year. Meanwhile, the part laid off produced a loss of over \$1.5 billion for the reinsurers. Thus, the issuing company wrote at a combined ratio of well under 110 while its reinsurers, participating in precisely the same policies, came in considerably over 140. This result was not attributable to natural catastrophes; it came from run-of-the-mill insurance losses (occurring, however, in surprising frequency and size). The issuing company's 1985 report is not yet available, but I would predict it will show that dramatically unbalanced results continued.

A few years such as this, and even slow-witted reinsurers can lose interest, particularly in explosive lines where the proper split in premium between issuer and reinsurer remains impossible to even roughly estimate. The behavior of reinsurers finally becomes like that of Mark Twain's cat: having once sat on a hot stove, it never did so again - but it never again sat on a cold stove, either. Reinsurers have had so many unpleasant surprises in long-tail casualty lines that many have decided (probably correctly) to give up the game entirely, regardless of price inducements. Consequently, there has been a dramatic pull-back of reinsurance capacity in certain important lines.

This development has left many issuing companies under pressure. They can no longer commit their reinsurers, time after time, for tens of millions per policy as they so easily could do only a year or two ago, and they do not have the capital and/or appetite to take on large risks for their own account. For many issuing companies, gross capacity has shrunk much closer to net capacity - and that is often small, indeed.

At Berkshire we have never played the lay-it-off-at-a-profit game and, until recently, that put us at a severe disadvantage in certain lines. Now the tables are turned: we have the underwriting capability whereas others do not. If we believe the price to be right, we are willing to write a net line larger than that of any but the largest insurers. For instance, we are perfectly willing to risk losing \$10 million of our own money on a single event, as long as we believe that the price is right and that the risk of loss is not significantly correlated with other risks we are insuring. Very few insurers are willing to risk half that much on single events - although, just a short while ago, many were willing to lose five or ten times that amount as long as virtually all of the loss was for the account of their reinsurers.

In mid-1985 our largest insurance company, National Indemnity Company, broadcast its willingness to underwrite large risks by running an ad in three issues of an insurance weekly. The ad solicited policies of only large size: those with a minimum premium of \$1 million. This ad drew a remarkable 600 replies and ultimately produced premiums totaling about \$50 million. (Hold the applause: it's all long-tail business and it will be at least five years before we know whether this marketing success was also an underwriting success.) Today, our insurance subsidiaries continue to be sought out by brokers searching for large net capacity.

As I have said, this period of tightness will pass; insurers and reinsurers will return to underpricing. But for a year or two we should do well in several segments of our insurance business. Mike Goldberg has made many important improvements in the operation (prior mismanagement by your Chairman having provided him ample opportunity to do so). He has been particularly successful recently in hiring young managers with excellent potential. They will have a chance to show their stuff in 1986.



Our combined ratio has improved - from 134 in 1984 to 111 in 1985 - but continues to reflect past misdeeds. Last year I told you of the major mistakes I had made in loss-reserving, and promised I would update you annually on loss-development figures. Naturally, I made this promise thinking my future record would be much improved. So far this has not been the case. Details on last year's loss development are on pages 50-52. They reveal significant underreserving at the end of 1984, as they did in the several years preceding.

The only bright spot in this picture is that virtually all of the underreserving revealed in 1984 occurred in the reinsurance area - and there, in very large part, in a few contracts that were discontinued several years ago. This explanation, however, recalls all too well a story told me many years ago by the then Chairman of General Reinsurance Company. He said that every year his managers told him that "except for the Florida hurricane" or "except for Midwestern tornadoes", they would have had a terrific year. Finally he called the group together and suggested that they form a new operation - the Except-For Insurance Company - in which they would henceforth place all of the business that they later wouldn't want to count.

In any business, insurance or otherwise, "except for" should be excised from the lexicon. If you are going to play the game, you must count the runs scored against you in all nine innings. Any manager who consistently says "except for" and then reports on the lessons he has learned from his mistakes may be missing the only important lesson - namely, that the real mistake is not the act, but the actor.

Inevitably, of course, business errors will occur and the wise manager will try to find the proper lessons in them. But the trick is to learn most lessons from the experiences of others. Managers who have learned much from personal experience in the past usually are destined to learn much from personal experience in the future.

GEICO, 38%-owned by Berkshire, reported an excellent year in 1985 in premium growth and investment results, but a poor year - by its lofty standards - in underwriting. Private passenger auto and homeowners insurance were the only important lines in the industry whose results deteriorated significantly during the year. GEICO did not escape the trend, although its record was far better than that of virtually all its major competitors.

Jack Byrne left GEICO at mid-year to head Fireman's Fund, leaving behind Bill Snyder as Chairman and Lou Simpson as Vice Chairman. Jack's performance in reviving GEICO from near-bankruptcy was truly extraordinary, and his work resulted in enormous gains for Berkshire. We owe him a great deal for that.

We are equally indebted to Jack for an achievement that eludes most outstanding leaders: he found managers to succeed him who have talents as valuable as his own. By his skill in identifying, attracting and developing Bill and Lou, Jack extended the benefits of his managerial stewardship well beyond his tenure.

#### **Fireman's Fund Quota-Share Contract**

Never one to let go of a meal ticket, we have followed Jack Byrne to Fireman's Fund ("FFIC") where he is Chairman and CEO of the holding company.

On September 1, 1985 we became a 7% participant in all of the business in force of the FFIC group, with the exception of reinsurance they write for unaffiliated companies. Our contract

runs for four years, and provides that our losses and costs will be proportionate to theirs throughout the contract period. If there is no extension, we will thereafter have no participation in any ongoing business. However, for a great many years in the future, we will be reimbursing FFIC for our 7% of the losses that occurred in the September 1, 1985 - August 31, 1989 period.

Under the contract FFIC remits premiums to us promptly and we reimburse FFIC promptly for expenses and losses it has paid. Thus, funds generated by our share of the business are held by us for investment. As part of the deal, I'm available to FFIC for consultation about general investment strategy. I'm not involved, however, in specific investment decisions of FFIC, nor is Berkshire involved in any aspect of the company's underwriting activities.

Currently FFIC is doing about \$3 billion of business, and it will probably do more as rates rise. The company's September 1, 1985 unearned premium reserve was \$1.324 billion, and it therefore transferred 7% of this, or \$92.7 million, to us at initiation of the contract. We concurrently paid them \$29.4 million representing the underwriting expenses that they had incurred on the transferred premium. All of the FFIC business is written by National Indemnity Company, but two-sevenths of it is passed along to Wesco-Financial Insurance Company ("Wes-FIC"), a new company organized by our 80%-owned subsidiary, Wesco Financial Corporation. Charlie Munger has some interesting comments about Wes-FIC and the reinsurance business on pages 60-62.

To the Insurance Segment tables on page 41, we have added a new line, labeled Major Quota Share Contracts. The 1985 results of the FFIC contract are reported there, though the newness of the arrangement makes these results only very rough approximations.

After the end of the year, we secured another quota-share contract, whose 1986 volume should be over \$50 million. We hope to develop more of this business, and industry conditions suggest that we could: a significant number of companies are generating more business than they themselves can prudently handle. Our financial strength makes us an attractive partner for such companies.

## Marketable Securities

We show below our 1985 yearend net holdings in marketable equities. All positions with a market value over \$25 million are listed, and the interests attributable to minority shareholders of Wesco and Nebraska Furniture Mart are excluded.

No. of Shares		Cost	Market
-----		-----	-----
(000s omitted)			
1,036,461	Affiliated Publications, Inc. ....	\$ 3,516	\$ 55,710
900,800	American Broadcasting Companies, Inc.	54,435	108,997
2,350,922	Beatrice Companies, Inc. ....	106,811	108,142
6,850,000	GEICO Corporation .....	45,713	595,950
2,379,200	Handy & Harman .....	27,318	43,718
847,788	Time, Inc. ....	20,385	52,669
1,727,765	The Washington Post Company .....	9,731	205,172
		-----	-----
		267,909	1,170,358
	All Other Common Stockholdings .....	7,201	27,963
		-----	-----
	Total Common Stocks	\$275,110	\$1,198,321
		=====	=====

We mentioned earlier that in the past decade the investment

environment has changed from one in which great businesses were totally unappreciated to one in which they are appropriately recognized. The Washington Post Company ("WPC") provides an excellent example.

We bought all of our WPC holdings in mid-1973 at a price of not more than one-fourth of the then per-share business value of the enterprise. Calculating the price/value ratio required no unusual insights. Most security analysts, media brokers, and media executives would have estimated WPC's intrinsic business value at \$400 to \$500 million just as we did. And its \$100 million stock market valuation was published daily for all to see. Our advantage, rather, was attitude: we had learned from Ben Graham that the key to successful investing was the purchase of shares in good businesses when market prices were at a large discount from underlying business values.

Most institutional investors in the early 1970s, on the other hand, regarded business value as of only minor relevance when they were deciding the prices at which they would buy or sell. This now seems hard to believe. However, these institutions were then under the spell of academics at prestigious business schools who were preaching a newly-fashioned theory: the stock market was totally efficient, and therefore calculations of business value - and even thought, itself - were of no importance in investment activities. (We are enormously indebted to those academics: what could be more advantageous in an intellectual contest - whether it be bridge, chess, or stock selection than to have opponents who have been taught that thinking is a waste of energy?)

Through 1973 and 1974, WPC continued to do fine as a business, and intrinsic value grew. Nevertheless, by yearend 1974 our WPC holding showed a loss of about 25%, with market value at \$8 million against our cost of \$10.6 million. What we had thought ridiculously cheap a year earlier had become a good bit cheaper as the market, in its infinite wisdom, marked WPC stock down to well below 20 cents on the dollar of intrinsic value.

You know the happy outcome. Kay Graham, CEO of WPC, had the brains and courage to repurchase large quantities of stock for the company at those bargain prices, as well as the managerial skills necessary to dramatically increase business values. Meanwhile, investors began to recognize the exceptional economics of the business and the stock price moved closer to underlying value. Thus, we experienced a triple dip: the company's business value soared upward, per-share business value increased considerably faster because of stock repurchases and, with a narrowing of the discount, the stock price outpaced the gain in per-share business value.

We hold all of the WPC shares we bought in 1973, except for those sold back to the company in 1985's proportionate redemption. Proceeds from the redemption plus yearend market value of our holdings total \$221 million.

If we had invested our \$10.6 million in any of a half-dozen media companies that were investment favorites in mid-1973, the value of our holdings at yearend would have been in the area of \$40 - \$60 million. Our gain would have far exceeded the gain in the general market, an outcome reflecting the exceptional economics of the media business. The extra \$160 million or so we gained through ownership of WPC came, in very large part, from the superior nature of the managerial decisions made by Kay as compared to those made by managers of most media companies. Her stunning business success has in large part gone unreported but among Berkshire shareholders it should not go unappreciated.

Our Capital Cities purchase, described in the next section, required me to leave the WPC Board early in 1986. But we intend to hold indefinitely whatever WPC stock FCC rules allow us to. We expect WPC's business values to grow at