

WHY BUFFETT'S A BARGAIN

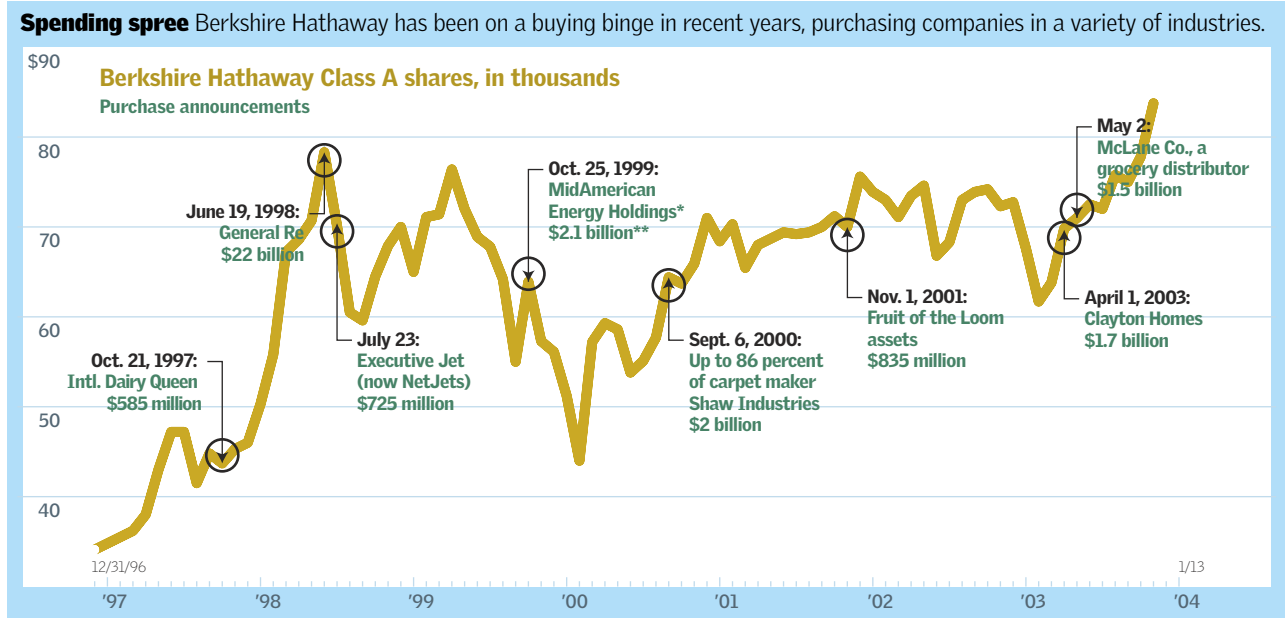
Investors who track Berkshire Hathaway say its stock is still undervalued. Shareholders, they say, get CEO **Warren Buffett's** services on the cheap too.

By Richard Teitelbaum

◀ On a January afternoon in 2002, Berkshire Hathaway Inc. Chief Executive Officer Warren Buffett was lunching at the Plaza Club, a members-only restaurant in his Omaha, Nebraska, office building. His guests that day included analyst William Fiala of Edward Jones & Co. As Buffett tucked into a plate of chicken au gratin—boned chicken covered in cheese and bacon—Fiala says he turned nervously to the billionaire to pose a question bedeviling investors. Who, he asked, will run Berkshire after its boss is gone?

Buffett, now 73, avoided the question. “Oh, he told me the usual stuff, that he had a name in his desk drawer and that the person doesn’t know it yet,” says Fiala, 36, who adds that he fears an heir may need years of mentoring to fill Buffett’s boots. “It’s a gamble on his part that he hasn’t started grooming someone to replace him.”

Succession is just one issue that has investors such as Fiala wondering whether Berkshire’s Class A shares are worth their Jan. 13 price of \$86,090, up 108.5 percent from their low of \$41,300 on March 10, 2000. (The company also issues Class B shares, which have $\frac{1}{30}$ of the Class A shares’ value and $\frac{1}{200}$ of their voting rights.) Others, such as Morgan Stanley equities analyst Vinay Saqi, points out that Berkshire’s insurance companies might be on the hook for future asbestos claims. Robert Hagstrom, manager of the \$340 million Legg Mason Focus Trust Inc., which sold its Berkshire stake in 2001, says the firm’s operating companies, like H.H. Brown Shoe Co. Inc. and Precision Steel Warehouse Inc., could languish—as faster-growing parts of the economy, such as Internet and computer companies, flourish. “You look at Warren Buffett, love him as we all do, and ask yourself why he didn’t buy Intel,” Hagstrom says.



Buffett himself says that his company might not always be a good buy. “The idea that Berkshire Hathaway could be the best stock to buy every day of the year over the last 10 years or the next 10 years, that’s nonsense,” Buffett said at Berkshire’s annual press briefing in May 2003. “There have got to be times when Berkshire itself is quite unattractive.”

This is not one of those times, say investors who track the company. A dozen analysts and money managers, employing different valuation methodologies, conclude that shares of Buffett’s company are, at a minimum, reasonably priced. Even after recent gains, some of them say, shares are trading as much as 29 percent less than what Buffett calls their “intrinsic value.” He defined the term in a 1996 booklet as “the discounted value of the cash that can be taken out of a business during its remaining life.”

The financial professionals who track Berkshire used three methods in particular to make the case that the stock is still undervalued: First, so-called look-through earnings adjust income to account for the billions of dollars of stocks the company holds. Second, a simple summing up of the parts separates Berkshire’s operating units from its stock and cash holdings. And third, a discounted cash flow analysis looks at the pool of money Berkshire’s insurance companies invest and adjusts future returns to reflect their present value.

Even a conservative estimate concludes that Berkshire is trading at a multiple of operating earnings only slightly more than that of the Standard & Poor’s 500 Index. So investors are paying what they would for an average big-capitalization company and getting the Omaha billionaire’s investment skills for free—or close to it.

Since Buffett took over Berkshire in 1965, per-share book value—the company’s net worth—has grown an annualized 22.2 percent, while the S&P 500 returned just 10 percent through 2002. Buffett, whose company shares were worth \$41 billion on Jan. 13, received an annual salary

of \$100,000 in 2003.

Because Berkshire is a conglomerate of diverse companies, valuing its shares makes for an Olympic-class challenge. Berkshire’s collection of insurance companies accounted for 59.5 percent of 2002 operating profits excluding investment gains for the nine months ended on Sept. 30. Insurers are difficult to value because many are subject to cyclical bouts of price cutting as well as catastrophes ranging from forest fires to terrorist attacks. “It’s basically a big puzzle that we spend oodles and oodles of time on,” says David Winters, CEO of Franklin Mutual Advisers Inc., which held 4,276 Class A shares and 121,987 Class B shares as of Sept. 30, worth a total of \$625.2 million at the time.

Berkshire is home to a lineup of more than 40 subsidiaries—or “sluggers” as Buffett called them in the company’s 2002 annual report, because many are industry leaders and generate large amounts of cash. These seemingly prosaic companies range from brickmaker Acme Building Brands to See’s Candies, to NetJets Inc., which sells fractional shares in jet aircraft. Berkshire is also known for the stakes its insurance firms hold in several brand-name companies: American Express Co., Coca-Cola Co., Gillette Co. and Wells Fargo & Co., among others. Berkshire’s positions in these major “investees,” as Buffett calls them, were worth \$31.1 billion as of Sept. 30.

Buffett also makes frequent bets on the markets, often using a stand-alone subsidiary, BH Finance, mostly for bond investments. In 2002, he plowed about \$7 billion into junk bonds. Berkshire, as of Sept. 30, had \$639 million invested in Hamilton, Bermuda-based hedge fund Value Capital LP.

It all adds up to a valuation morass that causes some investors to throw up their hands. “I don’t do any kind of valuation on it; it would be fatuous for me to do so,” says Hersh Cohen, comanager of the \$5.28 billion Smith Barney Appreciation Fund Inc., which had 6.9 percent of its assets in

Berkshire as of Dec. 31—its largest position. “Sometimes you’ve just got to go with the horse.”

Some investors, such as David Braverman, vice president, Standard & Poor’s Portfolio Advisors, describe Berkshire as a fund: the sum of the stocks, bonds and other holdings in its portfolio. Buffett, who declined requests to be interviewed for this story, panned that approach in his 1997 chairman’s letter, criticizing “pundits who ignore what our 38,000 employees contribute to the company.”

Matthew Sauer, comanager of the \$249.7 million Oak Value Fund, which had 11.1 percent of its assets in Berkshire as of Dec. 31, says treating the company as a fund gives short shrift to Buffett’s ability to reap cash from mature investments like the *Buffalo News* newspaper and redeploy the money in faster-growing companies such as carpet maker Shaw Industries Inc. “It’s a vehicle that allocates capital to a growing list of outstanding businesses with outstanding management,” Sauer says.

Berkshire has changed markedly over the past six years to become more like a collection of companies and less like an investment vehicle. Haywood Kelly, research director at Morningstar Inc., a Chicago firm that analyzes and rates stocks and funds, calculates the asset value of Berkshire’s operating units, including insurance, and compares it with the values of Berkshire’s other holdings: stocks, bonds and cash. Excluding BH Finance, goodwill and some minor assets, Kelly found the publicly traded stocks accounted for 72.9 percent of Berkshire’s assets in 1997. That figure was down to 25.8 percent at the end of 2002. The operating units rose to 30.2 percent of assets in 2002 from just 4.4 percent in 1997. (Bonds and cash represented 22.7 percent of assets in 1997 versus 44 percent in 2002.)

The changing mix largely reflects a six-year spending spree during which Berkshire has focused on buying whole companies rather than stocks. In his public statements, Buffett has said he prefers to buy companies because he has the ability to change management, set compensation and influence other corporate policies. Companies Berkshire has bought during the past two years include Clayton Homes Inc., a manufactured-home company; McLane Co., a grocery distributor; and the assets of underwear maker Fruit of the Loom Ltd.

Berkshire’s profit and book value rose sharply for the first nine months of 2003. Excluding investment gains, earnings rose 38.9 percent to \$3.88 billion from \$2.8 billion for the comparable period in 2002. For the four years through 2002, book value grew at an average rate of less than 3 percent. For the first nine months of 2003, growth in book value, which in

annual reports Buffett has said should move in tandem with intrinsic value, was 12.4 percent—an annualized rate of 16.5 percent. Book value as of the end of September was \$72 billion versus \$64 billion at the end of 2002.

A principal reason for the gains was a turnaround at General Re Corp., which had a pretax underwriting gain of \$117 million for the first nine months of 2003 versus a loss of \$666 million for the comparable 2002 period. General Re, like other reinsurers, writes policies in which it agrees to pay off part of the losses that other, so-called primary insurance companies could face as a result of their underwriting.

In Berkshire’s 2001 annual report, Buffett declared that General Re had broken every basic property and casualty underwriting rule, including writing policies in the interest of gaining market share instead of profitability. The firm amassed more than \$7 billion in underwriting losses in the first four years following Berkshire’s 1998 acquisition. Under Joseph Brandon, who took over as CEO just days before the Sept. 11, 2001, terrorist attacks, underwriting discipline has been restored, Buffett says in the 2002 annual report.

To evaluate an insurance company, analysts examine its float: the pool of money received by the insurer from policyholders as premiums and not yet paid out in the form of claims. Firms use the float as capital, investing it to earn a return before they pay claims. The cost of the float, along with how much it earns and how fast it grows, determines the ultimate value of an insurer. Unlike some of its rivals such as SCOR, General Re collected more in premiums than it expected to pay out in claims during the first nine months of 2003, meaning that it earned an estimated return of almost 1 percent even before investing.

General Re, after suffering more than \$1.5 billion in losses related to the 2001 terrorist attacks, has been able to raise rates since then, as have competitors. The firm has a further advantage in that it and another Berkshire firm, National Indemnity Group,

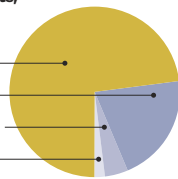
are the last two major reinsurers rated AAA by S&P. The highest credit rating carries with it the perception of rock-solid financial strength, which makes the Berkshire firms the reflexive first choices for insurers trying to offload risk, Morningstar’s Kelly says. That lets Berkshire charge more or set more-advantageous terms, such as big deductibles, he adds.

The insurance companies also contribute to the difficulty in assessing Berkshire’s value, says Harry Burn III, 60, comanager of the Greenwich, Connecticut-based, \$1.01 billion Sound Shore Fund. Looking out his office window at sun-dappled Long Island Sound, he says he came to own Berkshire Hathaway stock—now the

A changing mix Berkshire Hathaway has become less dependent on stocks as it has bought more companies.

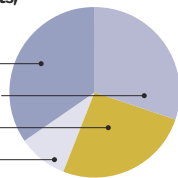
Berkshire Hathaway’s assets,* 1997: \$50 billion

Stocks: **72.9%**
Bonds: **20.7**
Operating businesses**: **4.4**
Cash: **2**



Berkshire Hathaway’s assets,* 2002: \$110 billion

Bonds: **34.6%**
Operating businesses**: **30.2**
Stocks: **25.8**
Cash: **9.4**



*Excludes BH Finance, goodwill and some minor assets. **Based on asset value of operating businesses. Source: Morningstar

fund's largest position, at 4.9 percent of assets—in an indirect fashion: Four years ago, Berkshire teamed up with senior management to buy out MidAmerican Energy Holdings Co., a utility in which Sound Shore held a stake. The purchase prompted Burn to focus on Berkshire, which on the surface did not meet many of the criteria that Sound Shore usually demands; the fund looks for undervalued stocks, many of which pay dividends and have low price-earnings ratios. Berkshire does not pay a dividend; nor did its P/E multiple seem low relative to its past history or to other stocks. "With Berkshire, the statistics are never going to come across a screen that make you stand up and leap and shout, 'Gosh, it's so cheap,'" says Burn, who began buying Berkshire shares in March 2001 and last added to his fund's position in October 2003.

Based on Berkshire's \$85,974 share price on Jan. 9, and Thomson Financial's consensus analysts' earnings estimate of \$3,411 a share in 2003, the stock trades at a multiple of 25.2 compared with 20.6 for the S&P 500. "A lot of investors say they don't want to pay that kind of multiple for Berkshire," says Mark Curdin, 36, a Sound Shore analyst. "What they are not realizing is that they're paying for a lot of things that don't find their way to the net income figure—like the companies in its stock portfolio and its cash."

For a professional money manager, placing a big chunk of money into Berkshire requires a contrarian disposition, says silver-haired Burn. The stock is not in any major index, largely because of the five-digit price tag on the Class A shares and their low trading volume; fewer than 100 shares change hands on many days. There are only five brokerage analysts covering it, according to Bloomberg data, and Wall Street discounts conglomerates because they're complicated. "The Street likes to have a story that is easily communicated," Burn says. "This is not an institutionally appealing stock."

The first valuation method, using what Buffett calls "look-through earnings," adjusts for some of the idiosyncrasies of financial reporting. Starting in 1991 through 2000, Berkshire often provided look-through earnings figures in its annual reports in addition to the standard ones based upon generally accepted accounting principles, or GAAP. Look-through earnings show what Berkshire's proportionate share of the after-tax, operating income of the stocks it owns would have been had they been consolidated into Berkshire's earnings—something not allowed under current GAAP rules.

Analysts such as Edward Jones's Fiala say that, using a look-through approach, Berkshire's 11.8 percent stake in American Express entitles the firm to a like percentage of the company's after-tax operating earnings: an estimated \$299.9 million in 2003, with dividend income subtracted to avoid double counting. In addition, gains on investments are stripped out in calculations of look-through earnings because those are realized only when management chooses to sell securities.

Look-through earnings make Berkshire more attractive from a P/E perspective. Using the method, Fiala calculates that 2003 forecast earnings are understated by \$877.9 million or \$571.72 per share. Adding that figure to Thomson Financial's earnings-per-share estimate of \$3,411, Berkshire's P/E multiple for 2003 was 21.6 compared with 20.6 for the S&P 500. That's one reason Fiala rates the stock a buy. "The reported operating earnings are so misleading, because they're always understated," says Fiala. "The look-through approach is the best way to get a sense of what you're really paying."

Covering the company run by the world's most acclaimed investor can be intimidating, says Fiala, who confesses to feeling some anxiety when he's met Buffett. "You have to get by the personalities," he says. And Fiala admits to being extra careful in his calculations and research reports. "I probably double-check my notes and then probably triple-check them," he says.

The second approach to valuing Berkshire—a simple sum-of-the-parts analysis—again takes its cue from the company's past annual reports, this time for the five years from 1995 through '99. Each year during that period, Buffett suggested shareholders look at Berkshire as two distinct parts: first, the value of the investments it holds, and second, the pretax earnings of its operating units, excluding investment income and gains. Over the years, Berkshire provided both figures in its annual report. In 1998, the value of investments per share was \$47,647, and pretax earnings with investment income excluded were \$474.45 per share.

Breaking Berkshire apart in this way suggests that the company is cheaper than the S&P 500. The math is easier than with look-through earnings, and the concept is similar because it adjusts the P/E multiple to compensate for the aspects of GAAP that make Berkshire appear so expensive: the fact that stock and cash holdings have so little effect on the earnings. "Conceptually, you know the cash is worth the cash," says Oak Value's Sauer, whose fund has maintained

Ballpark figure Valuing Berkshire this way reduces its P/E to 21.6 from 25.2, based on estimated 2003 operating earnings.

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LOOK-THROUGH EARNINGS

Berkshire's share of portfolio companies' estimated 2003 after-tax operating earnings, minus dividends*; in thousands, except per share data

| | |
|---|------------------|
| American Express | \$299,900 |
| Coca-Cola | 228,500 |
| Gillette | 72,800 |
| H&R Block | 43,000 |
| M&T Bank | 28,500 |
| Moody's | 51,300 |
| Washington Post | 26,000 |
| Wells Fargo | 127,700 |
| Other | 200 |
| Total earnings understatement | 877,900 |
| Analysts' 2003 consensus, Berkshire earnings estimate** | 5,237,693 |
| Total estimated 2003 look-through earnings | 6,115,593 |
| Look-through earnings per Class A share | \$3,983 |
| P/E ratio | 21.6 |

*Figures are based on positions in the portfolio companies as of Dec. 31, 2002. **Based on \$3,411 per Class A share. As of Jan. 9. Sources: Bloomberg, Edward D. Jones & Co., Standard & Poor's, Thomson Financial

its Berkshire position since 1998. “And the equity portfolio is worth the market price of the stocks: Coke and Gillette have been trading at their current multiples for years, so it’s not like you’re backing out the market value of an inflated Internet stock.”

In their version of the sum-of-the-parts method, Burn and Curnin begin by adjusting the numerator of the P/E: the market price of Berkshire Hathaway, which had a total market capitalization of \$132 billion on Jan. 9. They then subtract from that the \$27 billion in cash that Berkshire held on Sept. 30. That leaves a market value ex-cash of \$105 billion. Then they strip out the market value of Berkshire’s equity holdings—\$31.1 billion on Sept. 30—less the \$7.8 billion in deferred taxes that would have to be paid on the appreciated shares. That results in a pro forma market price of \$81.7 billion, or \$53,227 a share.

Next, in a parallel fashion, they adjust Berkshire’s reported earnings—the denominator of the P/E multiple. They start with Thomson Financial’s 2004 consensus earnings-per-share estimate of \$3,732, equivalent to total net income of \$5.73 billion. When they strip out all income derived from stocks and cash, they arrive at an adjusted pro forma earnings figure. The estimated interest income from Berkshire’s big cash position (assuming a 1 percent after-tax yield) is \$270 million. And dividends on the stock portfolio holdings total \$454 million, assuming a tax rate on the dividends of 14 percent. After subtracting interest income and dividends, pro forma net income is \$5.01 billion, or \$3,260 a share.

Dividing \$53,227 by \$3,260 results in a pro forma 2004 P/E multiple on the shares of just 16.3, a 14 percent discount

the market.”

Sauer, 42, a 5-foot-9-inch marathon runner, says even this method minimizes Buffett’s investing acumen. “The cash is investable capital with the world’s best investor,” he says. Sauer’s company maintains a Web site that publishes reviews of Berkshire’s annual meetings that have made the case that the stock is undervalued. An example from the latest review: “The company has stood out like Superman in a universe of Bizarro impostors.”

The third way to put a fair market price on Berkshire stock is through discounted cash flow analysis—projecting how much money it will make in the future and reducing, or discounting, it by a percentage amount each year to arrive at its present value. Complicating the issue are Berkshire’s sprawling insurance holdings. To project how much cash the insurers will generate in the future, analysts must first estimate three crucial variables: after-tax returns and the annual growth and annual cost of the insurers’ float. That’s one reason it’s sometimes called float valuation analysis.

Discounted cash flow analysis, more than other methods, is subject to the bias of the assumptions. In a November 2002 report, Morgan Stanley analyst Alice Schroeder, who pioneered float-based analysis, used a 5 percent discount rate in one of her calculations that pegged Berkshire’s value at \$124,411. In May 2003, she took a leave to write a book with Buffett.

Sound Shore’s Burn and Curnin begin their discounted cash flow analysis by splitting Berkshire’s \$43.4 billion insurance float in three. Geico Corp. controls an estimated \$5.05 billion; General Re, \$23.3 billion; and the rest of the insurance companies, about \$15 billion. They assume all three groups earn the same, 10 percent pretax returns on that float in the future. Partly because Geico has an efficient business model—it sells car insurance directly to consumers via telephone and the Internet—the cost of its float is far cheaper than that of the other insurance companies. So Burn and Curnin project Geico’s cost of float going forward to be negative 6.5 percent; that is, it earns a positive return of 6.5 percent on the float before investing it. They estimate the cost of both General Re’s and the other insurers’ floats to be zero.

Next, Burn and Curnin assume a decline in the growth of float at all three groups. For Geico, whose float grew 10 percent in 2002, they assume float growth slowed to 8 percent in 2003 and will slow to 7 percent in 2004 and 2005 and to just 5 percent from 2006 through 2013. They project it will grow at just 4.5 percent in perpetuity after that. For General Re and the other insurers, Burn and Curnin assume a greater drop in float growth: to 5 percent from 2003 through 2005, to 3.5 percent from 2006 through 2013 and to just 3 percent in perpetuity after that.

Burn and Curnin call these projections conservative. To discount the cash flow to its present value in their model, they use 7 percent, which has been the approximate average yield for the past 10–15 years on U.S. Treasury bonds. Dis-

Analyze this The following valuation shows Berkshire’s shares are trading at just 16.3 times 2004 operating earnings estimates versus 18.6 times for the S&P 500.

2 SUM OF THE PARTS
In millions, except per-share data

| | |
|--|----------------|
| Berkshire Hathaway market value* | \$131,964 |
| Minus cash and cash equivalents, as of Sept. 30, 2003 | 26,952 |
| Minus after-tax value of stock portfolio, as of Sept. 30, 2003 | 23,308 |
| Pro forma market value | 81,704 |
| Market value per Class A share | 53,227 |
| Analysts’ 2004 consensus earnings estimate** | 5,729 |
| Minus after-tax interest income from cash | 270 |
| Minus after-tax dividends on stock portfolio | 454 |
| Pro forma earnings | 5,005 |
| Earnings per Class A share | \$3,260 |
| P/E ratio | 16.3 |

*As of Jan. 9. **Based on \$3,732 per Class A share. Sources: Berkshire Hathaway, Bloomberg, Sound Shore Management, Thomson Financial, Zacks Investment Research

to the S&P 500. If Berkshire were priced at a market multiple using this method, shares would trade at \$93,000. “We think that’s a bargain,” says Burn. “We’re getting a AAA company—with no leverage, no stock options, a very small amount of debt and high-quality earnings—at a discount to

counted by that percentage, the present value of the float is \$97.7 billion.

Burn and Curnin then add in the insurance firms' projected 2003 capital—\$32.7 billion—as well as \$4 billion to adjust for the deferred tax liability on Berkshire's long-term portfolio holdings, on which Berkshire earns additional returns. Rather than using discounted cash flow analysis on the noninsurance units, Burns and Curnin estimate they'll earn \$2.38 billion in 2003. Using a conservative multiple of 15 times earnings, they put their value at \$35.7 billion. By those numbers, Burn and Curnin say Berkshire deserves a market value of \$170.1 billion, or \$110,787 per share. That means Berkshire's shares trade at a 29 percent discount to intrinsic value.

Most attempts to value Berkshire stock fail to capture Buffett's wizardry in deploying cash, says Robert Miles, author of *Warren Buffett Wealth: Principles and Practical Methods Used by the World's Greatest Investor* (John Wiley & Sons, 2004). Miles figures Buffett has about \$150 million to invest every week. That money can be put into new enterprises like Garan Inc., the children's clothing maker Berkshire bought in September 2002, or plowed into bonds or new areas—anywhere Buffett sees profits. "He has an unlimited canvas," Miles says.

It's Buffett's investing skill that makes him seem irreplaceable to many Berkshire shareholders—and that rattles them when worries surface about his health. In February 2000, Class A shares dropped 11.5 percent in one week when an Internet rumor circulated that Buffett was ill. Four months later, they fell 4.6 percent the week Berkshire announced he was entering the hospital for surgery to remove benign colon polyps. "If shares go up when he dies, Buffett himself has said that he will be very peeved," Miles says.

Legg Mason's Hagstrom, author of *The Warren Buffett Way: Investment Strategies of the World's Greatest Investor* (John Wiley & Sons, 1994), says the next great buying opportunity for Berkshire shares will be at the time of either a major terrorist attack or news of Buffett's death or in-capacity. "Emotionally, if Warren Buffett goes, the stock will go down in its first week," says Hagstrom, whose office in Bryn Mawr, Pennsylvania, is decorated with framed covers of his three books about Buffett. "I will be a big buyer then."

According to Buffett's public statements, almost all of his 31 percent stake in the company will pass to his wife, Susan, 71. Upon her death, the money will go to the Buffett Foundation, his charitable organization. At that point, the foundation could become the wealthiest in the U.S., says Steven Lawrence, director of research at the Foundation Center, a New York organization that provides philanthropy analysis. The largest foundation, according to 2001 figures, was the Bill & Melinda Gates Foundation, with \$23.3 billion in assets.

The Buffett Foundation will have to satisfy a U.S. Internal Revenue Service regulation known as the 5 percent rule, Lawrence says. The rule says 5 percent of the previous year's assets must be spent annually. That leads some investors to

suggest that Berkshire would then begin to pay a dividend, so that the foundation would not have to sell shares, which might put pressure on the stock price. "Berkshire Hathaway then becomes a huge cash machine," says Hagstrom. "The market reprices the stock when it realizes it's going to be a big dividend payer."

It's possible Buffett won't wait to pay a dividend given Berkshire's growing cash horde and his stated belief that there are few attractive investment opportunities available these days, says Jean-Marie Eveillard, 64, comanager of the \$5.03 billion First Eagle Global Fund, which had 1.4 percent of its assets in Berkshire as of Dec. 31. "Buffett has enough humility to say, 'I can't invest this cash. I'll return it to shareholders,'" Eveillard says. "There is nothing wrong with being a cash cow."

Buffett, at the 2003 press briefing, said the needs of the foundation will not determine whether a dividend gets paid. "Berkshire's dividend policy will relate to the opportunities it has to use capital, and that could change over time," he said.

The question of succession will likely continue to vex Berkshire investors, and that uncertainty may be a drag on the company's shares. As Eveillard puts it, "You could certainly justify a higher premium if Buffett was 63 rather than 73."

In October 2000, Berkshire stated three people will replace Buffett: his eldest son, Howard, 49, as chairman; Louis Simpson, 67, co-CEO of Geico as head of investments; and a third, unnamed person as CEO. At the 2003 press briefing, Buffett said he had drawn up a list of possible replacements and that four people within Berkshire were capable of doing his job. "I don't think I would want somebody to succeed me who was in his 60s, for example, because I think anybody ought to have a long run at it," Buffett said. "So as the years pass, certain people might go off the list that would otherwise be on the list simply on an age basis. Others might go on or off the list for other reasons."


If Buffett remains in his position for more than 10 years, the field of candidates to replace him becomes more fluid. "The options of the directors in case anything happens to Warren get better with every passing year," Charles Munger, 80, Berkshire's vice chairman, told reporters at the press conference. According to Miles, the lead candidate to run the investing side of the company after Simpson is Tom Bancroft, a Simpson deputy. Because of the steady profitability of Geico, Miles says, Tony Nicely, 60, a co-CEO of the auto insurer, would be a natural for the CEO job, as would General Re CEO Joseph Brandon, 44. Other logical picks, says Miles, are Ajit Jain, 52, president of Berkshire Hathaway's reinsurance unit, and Richard Santulli, 59, head of NetJets. An emerging candidate for the CEO spot, says Miles, is David Sokol, 47, CEO of MidAmerican, who could win the spot given Buffett's statements that he sees MidAmerican as a vehicle for future energy acquisitions.

Fiala says the experience of General Electric Co. shareholders is instructive on the issue of Buffett's succession. Jack Welch retired at age 65 in September 2001 after more than

20 years, during which time shares returned 21.3 percent on average annually versus 13.9 percent for the S&P 500. GE traded at a multiple of more than 20 percent higher than the S&P 500 in mid 2001. After a public three-way horse race, Jeffrey Immelt beat out two rivals—James McNerney and Robert Nardelli—for the top position. (McNerney left to become CEO of 3M Co., and Nardelli to head Home Depot Inc.) “Jack Welch had built up all these expectations and a high share price,” Fiala says. “When Immelt took over, the talk was about accelerating earnings of 18 or 19 percent.” The upshot is that shareholders have punished GE stock, which now trades at about the same multiple as the S&P 500. “Expectations acknowledged the possibility of a recession,” says GE spokesman David Frail. “Despite the World Trade Center attacks, GE ended 2001 with earnings growth of 11 percent.”

Buffett, by contrast, has done a much better job of managing the stock price, says Fiala. “With Berkshire Hathaway, I don’t see those same, superhigh expectations,” he says.

Buffett often warns investors, in public and in annual reports, that the best returns of Berkshire Hathaway are long behind it. In the 2002 annual report, he said he’d found few exciting prospects in the market and that earnings benefited from gains that are unlikely to be repeated. Buffett has also advised investors to heed the law of large numbers: Because of Berkshire’s size, he says, it cannot possibly come close to the 22.2 percent annual growth in book value that it achieved through 2002.

Buffett’s loyal investors tend to ignore such advice—with some reason. “I now feel we are much closer to the point where increased size may prove disadvantageous,” Buffett wrote in one letter. “As circumstances presently appear, I feel substantially greater size is more likely to harm future results than to help them.” That letter was sent to partners of Buffett Partnership Ltd., his long-since-closed investment company. It was dated Jan. 20, 1966. 

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Go with the flow Using one firm’s estimates of Berkshire’s value, its shares trade at a 29 percent discount to fair value.

3 DISCOUNTED CASH FLOW ANALYSIS
In millions, except per-share data

| | |
|--|------------------|
| Present value of insurance float,* 2004–13 | \$27,735 |
| Present value of insurance float* after 2013 | 69,963 |
| Tangible insurance capital | 32,660 |
| Adjustment for deferred tax liability on stock portfolio** | 4,000 |
| Value of noninsurance businesses | 35,700 |
| Total fair-market value | 170,058 |
| Fair-market value per Class A share | \$110,787 |
| Discount to fair value | 29% |

*Policyholder payments that can be invested by Berkshire firms before claims are paid.
**Fifty percent of deferred taxes on gains in Berkshire’s stock portfolio are treated as a zero interest loan on which returns can be earned. As of Jan. 9. Sources: Bloomberg, Sound Shore Management, Standard & Poor’s