



Saturday with Jim: Investment Wealth - Durable or Transitory?

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Today, let's continue our fictional interview series with Warren E. Buffet, arguably America's greatest living investor. Mr. Buffet bought a failing textile company, Berkshire Hathaway, in the 1970's and turned it into one of the world's best long-term investments. Book value, or the value of the shareholder ownership stake, grew several thousand percent over the approximately 40 years Mr. Buffet has had the company. What are some of his views on wealth accumulation? Do financial securities which rest on the money making activities of businesses make sense for investors like us?

Gaia: Welcome, Mr. Buffet.

WB: I am pleased to speak with you and your clients.

Gaia: Will you describe the principles you used to grow your wealth several thousand times over?

WB: I had a vision at the outset. I wanted to grow my wealth and that of our shareholders through compounding – the utilization of income to generate more income. I simply applied this principle over and over again as opportunities presented.

Gaia: How is that?

WB: I selected the insurance company as my basic cash generator. As you know, insurance companies take in more money in premiums than they pay out in a given year. This is called the float. The float is a large reserve against future losses by insured clients. The float represents a huge investment opportunity. We can predict, with some accuracy, how much of the float must be kept liquid in any given year to pay policyholder claims. The rest we invest in businesses which themselves have predictable and copious cash flow – other insurance companies, banks, consumer product and industrial companies and the like. These businesses are quite boring – candy makers, rug makers, tool and dye makers, aircraft leasing – all companies with predictable and growing cash flow. We also require that management have a proven track record of running efficiently and effectively and that they have an ownership stake large enough to align their interests with those of shareholders.

Gaia: Could you provide an example?

WB: Let's take GEICO, our auto insurance arm. We're not the cheapest company. But we reward policyholders for good driving records and we provide excellent claims service. These two things help us to attract a loyal customer base. GEICO sends us, the 80% owner, most of its profits from operations. With those profits and the profits of other Berkshire subsidiaries, we have a constantly flowing stream of cash to put to work buying other business and securities, many of which pay income. For example, last year we had cash when few others did. We bought several billion dollars of Goldman Sachs preferred securities which paid us 12% interest and which gave us the opportunity to buy Goldman common stock at about \$65 a share. We are still getting our 12% interest and the value of Goldman's shares has jumped to about 180. If we were to sell now, we would have tripled our money in the space of a little more than a year.

Gaia: Is the Goldman investment an example of using cash flow wisely or one of being in the right place at the right time with needed cash?

WB: Both. The Goldman experience shows us the value of patience in applying the funds from our operations. In 2006, we had over \$100 billion in cash and short-term investments. Many laughed at us and thought I lost my touch. But just two years later, the best investing opportunity in decades came along. Without the accumulated cash from operations, we'd have seen these opportunities but we would not have had the wherewithal to capitalize on them.

Gaia: What do you say to your clients who are worried about seeing their account balances rise and fall, with no apparent reason?

WB: In the short term – maybe even several months to a few years – the financial markets are voting machines. Investors with short tolerances and little patience buy this, sell that – with some technical reason or another. We prefer to see the markets as a money machine – taking the long view that we will prosper if we but keep to our strategy.

Gaia: How do you know that your money machine is working in the midst of the short term volatility and “noise”?

WB: I simply look at cash flow. If it's still increasing at a healthy pace and if there are no serious warning signs in the financial statements, I maintain confidence. But I apply patience to all of my decisions. I look for outsized relationships between risk and reward.

Gaia: Let's discuss the durability and sustainability of your approach with particular application to our clients – how can they know we are following a solid long-term path on their behalf?

WB: A solid question. Many of your clients may not be financially savvy. They may not understand that volatility (a seeming loss) may be meaningless, meaningful or it may be your friend. Your challenge, I think, is to translate your financial results into something they can understand. For example, you can show your income clients the relative stability of income in the face of account balance volatility. You can also emphasize that financial evaluation is as much an art as a science – but in essence you must know each client well enough to craft accounts that will match their needs and objectives with their REAL tolerance for risk. Securities wealth is durable, but it's at least somewhat volatile and its ups and downs may frighten some people out of investing... just at the wrong time.

Gaia: How can clients KNOW that their accounts are safe and productive?

WB: Reporting investment results to clients is the proverbial mousetrap – you can improve it forever and you still won't catch all of the mice. You must establish a “normal” volatility range for clients and

you must keep your investment results generally within it. You must show generally steady progress over time. You must also guard against excessive expectations, especially in times when speculation is running rampant or when fear is prompting their friends and relatives to seek the safety of cash (usually near the bottom). In essence, you must show clients a sustainable path and you must follow it. You must communicate well and often with your clients, too.

Gaia: Is your compounding model transferable to our clients?

WB: Absolutely. You can either invest in companies like ours with growing cash flow and expect that other investors will see the worth (in a rising stock price), or perhaps with more predictability and steadiness you can invest in securities which pay dividends. You can then use the cash flow you generate to buy more income producing securities, increasing both your cash flow and the wealth of your clients measured by the account balance. Successful investing is not at all a linear activity – steadily increasing or steadily decreasing. It’s a cyclical activity, with its ups and downs. The truly successful investor manages the ups and downs in such a way as to minimize risk and to maximize opportunity and gain.

Gaia: How does one minimize risk and maximize gain?

WB: By always buying with a margin of safety, a price that is below an “intrinsic” value, and by selling when intrinsic value is reached or exceeded. Securities alternate between undervaluation and overvaluation. It is the job of an investment manager to navigate the cycles which produce these extremes. By buying undervalued securities, especially those which pay income, the risk of a real loss (being forced to sell or following a company to bankruptcy) is reduced. By selling at prices above fair (intrinsic) value, you are also minimizing risk and, maybe as importantly, you are creating a pile of money to repeat the process – buy low and sell high. You don’t, of course, have to buy and sell with rapid frequency. But it is incumbent on you as a prudent manager not to push your luck when prices have moved so far that a small accident will cause the whole market to tumble like a house of cards.

Gaia: Thank you, Mr. Buffet. The example you set with Berkshire Hathaway is a guiding light for those of us who want to follow in your footsteps, creating in our own unique way a “house” built on solid cash flow.

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