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Barron's Cover

What's Wrong, Warren?

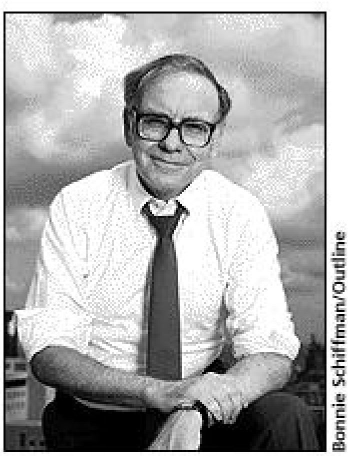
Berkshire's down for the year, but don't count it out

BY ANDREW BARY

After more than 30 years of unrivaled investment success, Warren Buffett may be losing his magic touch.

Shares in Buffett's **Berkshire Hathaway** are set to experience their first annual decline since 1990 and their second-worst year of performance, relative to the Standard & Poor's 500 Index, since Buffett took control of what had been a struggling New England textile maker in 1965.

At around $54,000 a share, **Berkshire's Class A** stock is off 23% in 1999, against an 18% return for the S&P 500 (including dividends). Berkshire has been hurt this year by weak operating results at its core insurance operations and by a rare annual drop in the company's famed investment portfolio, which includes such stocks as **Coca-Cola**, **Gillette** and **American Express**.



Warren Buffett's distaste for technology has soured performance.

But there's more to Berkshire's weak showing than just the operating and investment performance. To be blunt, Buffett, who turns 70 in 2000, is viewed by an increasing number of investors as too conservative, even passe. Buffett, Berkshire's chairman and chief executive, may be the world's greatest investor, but he hasn't anticipated or capitalized on the boom in technology stocks in the past few years.

Indeed, Buffett has even started taking flak on Internet message boards. One contributor called Berkshire a "middlebrow insurance company studded with a bizarre melange of assets, including candy stores, hamburger stands, jewelry shops, a shoemaker and a third-rate encyclopedia company [the World Book]."

Not everyone shares those sentiments, however. "I don't think Buffett has lost it," says Jim Engle, chief investment officer at Wood Struthers & Winthrop, a New York investment firm owned by Donaldson Lufkin & Jenrette. "Berkshire offers an incredible investment opportunity for those with a long time horizon."

Adds Peter Russ, an analyst at Fairholme Capital, a New Jersey money manager that holds Berkshire stock: "Berkshire's market value is less than **Yahoo**'s, yet Berkshire could earn $2 billion after taxes in 2000, while Yahoo will be lucky to make $200 million." Berkshire now is valued at $83 billion, while Yahoo has a capitalization of $120 billion. Russ believes that Berkshire could double over the next several years.

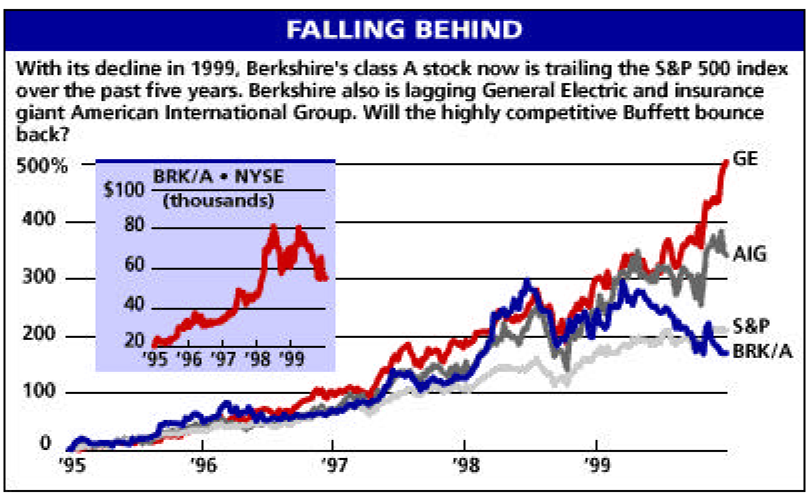
Bulls say the stock now looks very attractive, trading at around 1.5 times its book value and considerably below its March high of $81,000. Several Berkshire admirers told *Barron's* that they believe the stock's "intrinsic value" (a Buffett term meaning the essential worth of Berkshire's businesses, based on anticipated cash flows) is at least $75,000 a share, 35% above current levels.

Going Beyond Cigar Butts

Buffett began his career looking for beaten-down stocks in the tradition of his mentor, the illustrious Benjamin Graham. In the 1960s, this approach led him to the depressed but asset-rich Berkshire Hathaway.

But Buffett's genius was to go beyond Graham's limited world of socalled cigar butts-those with one good puff on them-and invest in great franchise companies like Coke and American Express, whose attributes lie outside the confines of their balance sheets.

Yet Buffett hasn't been able to make the next leap forward and adapt to the current technology-driven bull market. The reason: Technology isn't in Buffett's "circle of competence," and thus he doesn't feel comfortable seeking long-term winners in the sector. Buffett's avoidance of technology is ironic, given his longtime friendship with **Microsoft** Chairman Bill Gates. At the same time, Buffett's favorite sector, insurance, has been taking a beating. Late last year, Berkshire doubled its bet on insurance, paying $22 billion in Berkshire stock for General Re, the prominent reinsurer -- a deal that so far has proven a bust. Steering clear of the market's highflyers, Buffett has made other investments for Berkshire in the past two years, including the purchases of a furniture retailer and International Dairy Queen, and the pending acquisition of an Iowa-based electric utility, Mid-American Energy. These may turn out to be solid long-term deals for Berkshire shareholders, but none of them is setting hearts racing on Wall Street at a time when Internet stocks and other tech stars are doubling every few months.



FALLING BEHIND

With its decline in 1999, Berkshire's class A stock now is trailing the S&P 500 index over the past five years. Berkshire also is lagging General Electric and insurance giant American International Group. Will the highly competitive Buffett bounce back?

The secretive Buffett declined to speak with *Barron's*. But the rumblings from his headquarters in Omaha are that Buffett, a fiercely competitive man beneath his selfdeprecating, aw-shucks demeanor, feels his pride wounded.

There's even some speculation that Buffett may view Berkshire's stock as sufficiently depressed to implement the company's first major stock-buyback program. Berkshire certainly has the wherewithal, given what Buffett has called the corporation's "Fort Knox" balance sheet, which features minimal debt and $36 billion of bonds and cash. One of Buffett's few comments about Berkshire's valuation came in the 1998 annual report, in which he said that its intrinsic value "far exceeds book value," which stood at

$37,800 a share at year-end '98. Book value equals balance-sheet assets less debt, and thus doesn't fully capture the income-producing value of many of the company's businesses, including its Geico insurance unit.

Over the years, Buffett successfully urged the managements of Coke and **Washington Post**, another significant Berkshire holding, to repurchase stockdecisions that proved fortuitous, given the stocks' subsequent surges. Yet Buffett has never bought back an appreciable amount of Berkshire stock, believing he could find better opportunities elsewhere. If Berkshire has started to repurchase shares, it would be evident in the company's fourthquarter profit report, due in February. Buffett is unlikely to announce such a plan because it probably would raise the share price and make any buyback program more costly.

For his part, Buffett says his conglomerate possesses "a marvelous collection of businesses," including Geico, the fastgrowing auto-insurance company; See's Candies, the Buffalo News, FlightSafety International, the dominant pilot-training operation; Executive Jet, the leader in selling time shares in corporate jets, and Scott Fetzer, an industrial outfit that makes Kirby vacuum cleaners.

Buffett has much to be proud of. Berkshire's profits over the past three decades have compounded at a phenomenal 24% annual rate. In view of the company's large size, Buffett has told shareholders to scale back their earningsgrowth expectations to around 15% annually. Buffett also aims to increase Berkshire's intrinsic value by 15% per annum. This year, however, Berkshire isn't likely to accomplish either goal, largely because of poor results at General Re and a drop in the value of some investments, including Coke, Gillette and Freddie Mac.

PaineWebber's Alice Schroeder, one of only a handful of Street analysts following Berkshire, cut her 1999 and 2000 profits estimates following the company's weak third-quarter report last month. She now sees operating earnings, before a goodwill charge, of $982 per share, down 10% from 1998's level, and way below her early-year estimate of almost $1,300 a share. The company's book value should be about unchanged from last year's $37,800. Based on Schroeder's estimates, Berkshire trades at over 50 times projected 1999 profits, a lofty multiple. But the effective P/E is lower because the earnings reflect only the dividends received from the stocks in Berkshire's investment portfolio. "Look-through" profits, a theoretical number favored by Buffett that reflects the company's proportional interest in the earnings of the companies in the portfolio, are higher than reported profits.

Berkshire's stock may be down this year, but no one should grieve for Buffett, whose 32% stake is worth $26 billion. Buffett was America's richest individual in the early 1990s, but he has since been passed by Bill Gates and by two other Microsoft billionaires, cable baron Paul Allen and Microsoft President Steve Ballmer.

Berkshire has such a lofty share price because Buffett has refused to split the Class A stock. The company did issue **Class B shares**, which now trade at around $1,720 each, in 1996, when some financial entrepreneurs threatened to create lowpriced Berkshire unit trusts. Each B share is equivalent to 1/30 of an A share. The Class B stock trades at a 6% discount to the A shares, making the B shares a better bet in the eyes of some Berkshire fans.

Berkshire's Biggest Headache

Berkshire is widely viewed as Buffett's investment vehicle, but the reality is that, following the company's acquisitions in recent years, it has become much more than just a way to play such stocks as

Coke or Gillette.

"Ten years ago, you could argue that Berkshire amounted to a closed-end investment fund," says Fairholme Capital's Russ. "But now, it's really an insurance company headed by a unique investor who allocates capital and manages the investment portfolio."

Over 70% of Berkshire's operating revenues now come from insurance. The company's investment portfolio, recently valued at around $37 billion, accounts for under half its market value.

Buffett has built up Berkshire's operating side because he believes Berkshire generally does better acquiring entire businesses rather than taking passive stakes in large public companies at a time of lofty stock-market valuations.

When Berkshire controls companies, earnings flow up to the parent, where Buffett deploys the money as he sees fit. Stakes in public companies, in contrast, provide just dividend income to Berkshire.

Cover Story, Part 2[1]

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Cover Story, Part 2

Cover Story, Part 1[1]

Berkshire's biggest headache is General Re. Buffett thought he had scored a major coup when Berkshire reached a deal to buy the company in June 1998. In fact, Berkshire's stock hit a record $84,000 immediately after the announcement, amid enthusiasm for the deal. Gen Re is one of the leading global reinsurers. Such companies offer coverage to insurance companies that want to reduce their own risks.

Buffett figured that under Berkshire's umbrella, Gen Re would benefit because it could become more aggressive, taking on larger risks at opportune times without concern about the potential profit volatility. Buffett likes to say he prefers a "lumpy 15% return to a smooth 12%." Because investors place so much trust in Buffett, they've made Berkshire Hathaway one of the few publicly traded companies that isn't graded on each quarterly profit report.

Table: Losing Luster[2]

But so far, General Re has done poorly. Even before the transaction closed last December, the reinsurer set aside a $275 million pre-tax reserve for losses related to an ill-fated workers' compensation insurance pool called Unicover. And through the first nine months of this year, Gen Re has experienced an underwriting loss exceeding $600 million, $277 million of which came in the third quarter. Gen Re's operating loss has been offset by income from its investment portfolio, primarily bonds, resulting in a net profit for the year. Yet the results clearly are disappointing. PaineWebber's Schroeder noted in a recent report that many already are deeming Gen Re a "failure." On top of that, Berkshire partisans believe some of the pressure on Berkshire's stock is coming from former General Re shareholders, who are bailing out of the shares. Decades ago, Buffett realized that the beauty of the insurance business is that premiums are received before claims are paid, resulting in the opportunity for reinvestment. It was Buffett's insight to take those funds and shrewdly invest them in stocks, not bonds, the standard favorite of insurers. Moreover, Buffett's insurance operations historically have turned an underwriting profit, meaning Berkshire has earned money from both operations and investments. In stark contrast, the rest of the industry usually has been hobbled by underwriting losses.

Gen Re's woes may take time to fix. Berkshire stated in its third-quarter report that "premium rates for both the reinsurance industry and General Re are currently inadequate."

Geico has had weaker underwriting performance this year as well. But its results reflect heavy marketing spending to support its breakneck expansion effort, rather than any significant worsening in losses. Geico, which targets drivers directly, instead of through agents, is viewed as the best-run American car insurer. By cutting out agents, Geico possesses an appreciable cost advantage over its rivals. How appreciable? It's been estimated at 10 percentage points.

"Buffett is using Amazon.com-like tactics," says Wood Struthers' Engle. "He wants to grab market share quickly, despite what that does for near-term profitability. If he's right, and he can hold on to the new customers, it will prove to be a very profitable strategy."

Geico has poured money into its advertising and marketing campaign, which this year could total $200 million, up from $143 million in 1998. The campaign is working because Geico, which ended 1998 with 3.5 million customers, is expected to add a million net new clients this year. Even with the increase, Geico's share of the fragmented auto-insurance market is only 4%. Some think Buffett may not be satisfied until Geico has 10%.

Table: Buffett's Empire[3]

Geico's blitz has roiled the formerly staid auto-insurance industry, which prospered in recent years from reduced claims. But this year, insurers are getting battered by the combination of price declines and rising losses. J.P. Morgan insurance analyst Weston Hicks believes Geico will be successful because it offers the two things drivers want: low prices and good service.

Among Berkshire's other operating businesses, the only one excelling this year is flight services, which includes FlightSafety International and Executive Jet.

The investment portfolio, as noted, is set to decline this year, following a slight increase in 1998. The stock prices of Coke, the largest holding, and Gillette have each fallen 12% in 1999. Freddie Mac, the No. 4 stock in the portfolio at yearend 1998, is down 27%.

It's ironic that Coke and Gillette began to run into trouble after Buffett, in a rare moment of hubris, labeled those two companies "inevitables" in Berkshire's 1997 annual report. Coke and Gillette still have great global prospects and, in Buffett's words, "may dominate their fields for an investment lifetime." But both have stumbled in the past two years, raising doubts about whether they can resume high-teens annual profit growth for an extended period.

Absent from Berkshire's portfolio is technology. Asked at Berkshire's annual meeting in May why he hadn't bought Microsoft, Buffett replied: "If I had to bet on anybody [in technology], I'd certainly bet on Microsoft-and heavily. But I don't have to bet. And I don't see that world as clearly as I see the soft-drink world." Buffett recently told a group of Nebraska high-school students that he once told Bill Gates that explaining technology to him was a waste, that Gates would have "better luck with chimps."

Table: Rough Year[4]

Tom McManus, strategist at Banc of America Securities and a Berkshire investor, observes that a limitation of many of Berkshire's businesses, ranging from See's Candies to Coca-Cola, is that they're expanding at the rate of global economic growth, while technology companies are experiencing far stronger growth.

Another issue facing Berkshire is succession. Buffett remains in good health, but many investors are afraid to own Berkshire. They don't know whether anyone can come close to filling the old master's big shoes and whether Berkshire will lose its magical aura after Buffett departs.

It's tough to tell how Wall Street would react if Buffett were to die suddenly, but some think Berkshire stock could fall at least 10% and perhaps as much as 20%. The company's fans maintain that any sizable drop would be a major buying opportunity.

Buffett has said that his job will be split in two; one executive will run Berkshire's investments and another will oversee the operating businesses. He hasn't identified his choices publicly, other than to say they are part of Berkshire's organization.

The betting is that the investment operation will be headed by Lou Simpson, the longtime manager of the equity investment portfolio at Geico, which Berkshire fully absorbed in early 1996. Though he appears to have stumbled in the past year, Simpson, who still guides a $2 billion portfolio, had a great record from 1980 through the mid-1990s.

There's more uncertainty about who will run Berkshire's operating business because there are several capable executives at the various divisions. One rising star is Rich Santulli, head of Executive Jet. Buffett praised Santulli as a "terrific executive" in Berkshire's annual report. When Buffett buys companies like Executive Jet, he likes to keep management in place.

"You obviously can't expect Buffett's successors to be as gifted as him," says Engle. "But whoever the next guy is will have a lot of good businesses to work with."

It should be said that Buffett's interest in the company shows no signs of flagging. At Berkshire's annual meeting in May 1998, Buffett was asked why he hadn't written a book. He reportedly replied that he wanted to wait, saying: "Perhaps it's unwarranted optimism that leads me to think that the best is yet to come."

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