The Deals of Warren Buffett

Volume 3

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Volume 3
Making America's largest company

Glen Arnold

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First published in 2021.

Hardback ISBN: 978-0-85719-649-1
eBook ISBN: 978-0-85719-650-7

British Library Cataloguing in Publication Data
A CIP catalogue record for this book can be obtained from the British Library.

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About The Author

What works in investing?

That was the question Glen Arnold sought to answer in his tenure as professor of investing; drawing on academic insights, great investors' ideas and his own experiences to teach value investing techniques to students and to fund managers new and old.

Along the way, Glen authored the UK's bestselling investment book (*The Financial Times Guide to Investing*) and bestselling UK corporate finance textbook (*Corporate Financial Management*), alongside titles on value investing (*The Financial Times Guide to Value Investing*) and investment trailblazers (*The Great Investors*).

2013 saw Glen start a new chapter. Swapping his professorship for the real-world rigours of active fund management, Glen would test his ability to outperform the stock market by investing his own money using the lessons he'd learned during his academic career. In doing so, Glen would offer full public disclosure of his buy and sell decisions online in a newsletter to followers, sharing each success and struggle along his investment journey.

Glen's new fund management adventure saw him become a Berkshire Hathaway shareholder and attend many annual general meetings in Omaha.

Elsewhere in the audience – and unbeknown to Glen – was Tom Spain; another UK Buffett enthusiast building his own reputation for fund management by adopting Buffett and Munger's investment philosophies for his firm, Henry Spain. When several of their other investment choices overlapped, Glen and Tom found themselves attending the same annual general meetings, where they grilled directors with polite but penetrating questions that other shareholders rarely matched.

After eight years investing only his own money and that of his wife, Lesley, Glen was satisfied that he had proven his ability to outperform the stock market by applying the tested value investment techniques he'd taught for many years.

In 2021, Glen joined Henry Spain Investments to run an open fund focused on neglected, unloved and under-priced UK shares.

To find out more, go to henryspain.co.uk or glen-arnold-investments. co.uk.

Acknowledgements

This series of books would not have come about without a great deal of help from others. Firstly, I would like to thank Warren Buffett and Charlie Munger for their willingness to take time to help other investors by writing about and discussing publicly their philosophies and experiences in the adventure of investing. I'd also like to thank them for permitting the use of their material in this book, and for stewarding a portion of my savings held in Berkshire Hathaway shares.

Bill Child, who built R.C. Willey (the sixth investment in this book) into a billion-dollar furnishing retailer from a 600 sq. ft store, was very generous in offering to review the chapter written about his creation and its sale to Berkshire. He added some important material to give a richer picture. Thank you, Bill.

Many scholars have written about Berkshire Hathaway, Warren Buffett and Charlie Munger, not least Robert P. Miles, Carol J. Loomis, Adam J. Mead, Alice Schroeder, Roger Lowenstein, Robert G. Hagstrom, Lawrence A. Cunningham and Andrew Kilpatrick. I am grateful for their work, which creates a bedrock of well-researched and reliable sources of information.

Craig Pearce at Harriman House has been a more supportive and patient editor than I deserved (I was about a year late delivering the manuscript). He did a great job of editing the work and enthusing the rest of the team. Tracy Bundey, Charlotte Staley, Lucy Scott, Sally Tickner and Suzanne Tull at Harriman all played assiduous, creative and energetic roles to ensure the success of the book – thank you all.

The Origins Of This Book Series

It all began in 2013, when I took the decision to stop other activities to allow full concentration on stock market investing. This meant giving up a tenured professorship, ceasing teaching in the City of London and, ironically, pulling back sharply on writing books.

To create a record of the logical process in reaching a decision to select a share, I wrote blogs laying out my analysis on a simple website and made them free to all. It was galvanising to be forced to express clearly and publicly the reasoning behind allocating capital in a particular way. And besides, I needed a way to review, a few months down the line, the rationale for the investments made.

The blog became popular, and then the investment website ADVFN asked if I would transfer it to their newsletter page. I accepted, and one strand of my writing there became a series of articles about the rationale behind the investment deals of Warren Buffett (I didn't always have a potential investee company to analyse and I thought readers might be interested in Buffett's decision making, experiences and lessons). It is from those articles that this book has been created.

The 'Why?' question

You might think that Warren Buffett has been covered in dozens of published volumes and there is nothing new to say. But having read much of this literature myself, I was left unsatisfied. Other writers address what he invested in and how much he made from it. But I wanted to know why. What were the special characteristics of the companies Buffett chose that made them stand out? Was it in the balance sheet numbers, the profit history, the strategic positioning and/or the qualities of management? I wanted to know the detail. How did

Buffett go from step to step in rational investing, from having virtually no money to being very rich?

For each investment, this required fresh investigation, tapping many sources. The priority was to focus on the analysis of Buffett's selected companies, which meant very little time spent on his personal life, which has been thoroughly covered elsewhere.

I hope you enjoy reading how Warren Buffett turned Berkshire Hathaway into one of the greatest companies of all time.

Glen Arnold
Summer 2021

Preface

What this book covers

Warren Buffett was only just getting into his stride as he approached the normal retirement age. Already a billionaire, he just couldn't stop himself from 'tap-dancing' to work. He loved finding excellent companies at reasonable prices. Delving into what made a company tick was his idea of fun; he had the joy of seeing his analysis proved right time and again.

The analytical techniques he used are simple to explain as principles, such as find a good quality franchise run by competent and honest managers, and don't overpay. Stating these principles is one thing; applying them to companies is something else.

We so frequently find ourselves distracted by the less important firm characteristics, failing to put enough emphasis on absolute core elements.

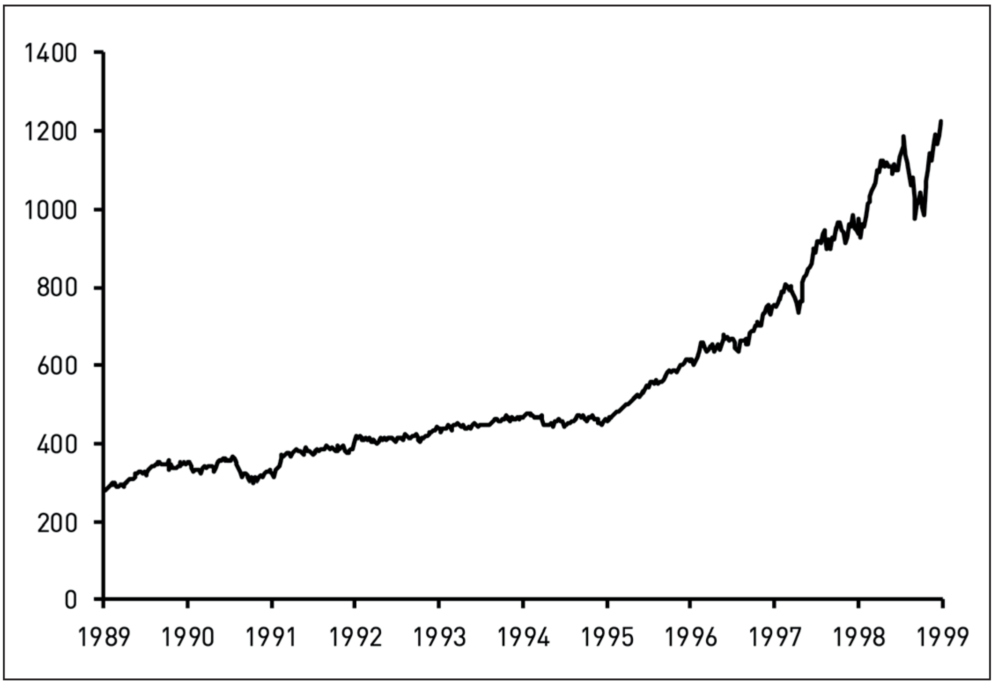
By examining Buffett's decisions and the analytical logic he used, we can gain some inoculation against asking the wrong questions or not giving enough emphasis to the truly vital factors.

This book examines ten fascinating deals which helped propel Berkshire Hathaway from a company with a market capitalisation of $5bn to one of the world's giants, with its shares valued by Wall Street at well over $100bn. And all this was achieved in just ten years, between 1989 and 1998. Warren Buffett and his wife Susan retained a 34% equity interest in the company and by 1998 had a holding worth tens of billions of dollars.

As in earlier periods, these deals are comprised of an intriguing mixture of family-led enterprises, such as FlightSafety International and Helzberg, alongside giants such as Wells Fargo and American Express.

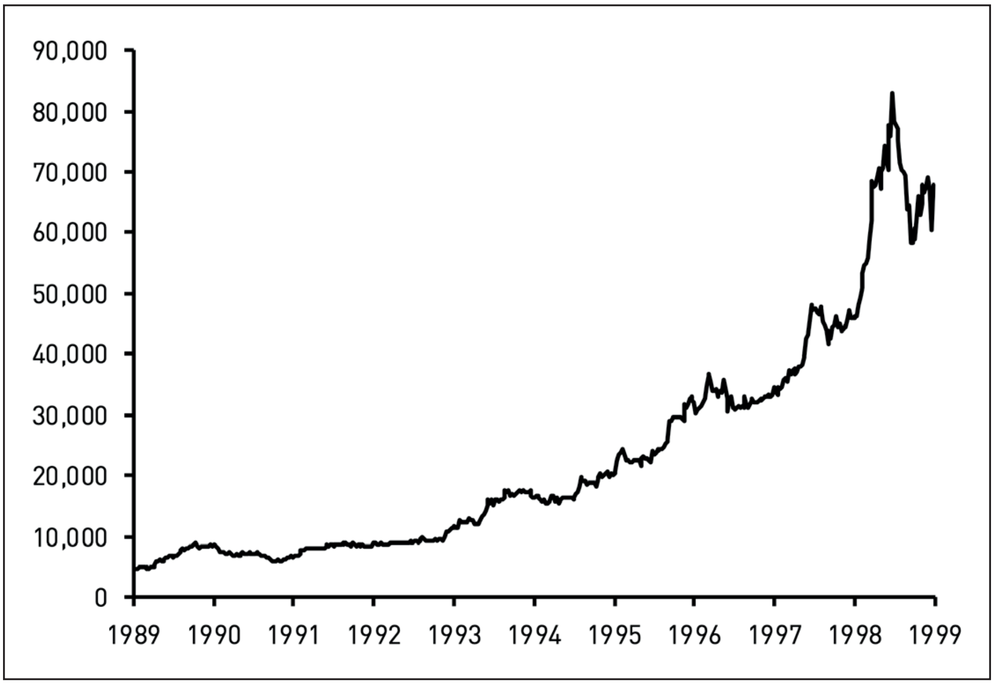
It has to be acknowledged that this remarkable performance occurred at a time of a stock market boom in the lead up to the dot-com bubble. But it's interesting to compare the performance of the booming market as a whole with that of Berkshire. Figure A shows that the S&P 500 rose over 300% over those ten years. Impressive, and more than enough to please the average investor if he or she had simply jumped in the market to ride it on its upward course.

Figure A: S&P 500 (January 1989–December 1998)



But Warren Buffett is not an average investor. His decisions, in partnership with Charlie Munger, caused the market value of Berkshire's shares to rise 14-fold, from $4,700 each to $68,000 in December 1998 (see Figure B). To put these numbers in context, when Buffett first bought into Berkshire Hathaway in 1962, he paid $7.50 per share.

Figure B: Berkshire Hathaway shares, USD (January 1989–December 1998)



Those of us who aspire to invest in a Buffett-like manner, and who carry the hope of raising our game sufficiently to move some way towards his performance, are keen to know the secrets behind raising portfolio value 14-fold over a decade.

This book is designed to help by looking at the rationale behind Buffett's choices and the lessons he, and we, can gain from his logic and experience. Most of the deals covered in this book were great successes but there were also failures. Buffett freely admits that he made many mistakes during this period. What is important for him is that he learned from them. And so can we.

The deals

Berkshire's buying of a large holding in **Wells Fargo**, the first case study here, came in two phases. The first, bought between 1989 and 1996, worked out brilliantly, producing at least $14 for each dollar put in. Buffett went against the consensus by investing at a time of recession in California, where Wells Fargo lent to businesses and families. He analysed the fundamentals and saw a strong franchise and balance sheet; a company that could ride out near-term trouble. It seems that the

Wall Street crowd couldn't see these factors, or at least could not bring themselves to weight them more than their fear of customer defaults.

The second phase of investment, 25 times as large as the first, can be counted as a failure, from which we learn many things – notably, the centrality of a culture of business integrity for long-term profitability (Wells' managers badly damaged the firm's long-cherished reputation). Buffett committed $12.4bn to Wells shares during the period 2003–15. The return on the $12.4bn was not negative, but it barely managed to keep pace with inflation, let alone with the rapidly advancing S&P 500.

At one stage Buffett had to mark down the 1989 investment in **USAir** to only 25c on the dollar. For years he thought he had lost most of the money invested. Fed up, he came out with glum humour, saying things like it would have been better if Orville had failed to get off the ground at Kitty Hawk because the more the industry grew the worse the disaster for owners. He also says he now calls a 0800 number if he ever has the urge to buy into airlines and says, "'My name is Warren, I'm an air-aholic' and they talk me down."

The American airline industry had appalling economics, with overcapacity and cut-throat pricing. Through this case study we learn many things, the most important being that business growth tells us little about value. Profitless growth is always possible, and quite common. Buffett describes his work prior to investing as consisting of sloppy analysis inspired by hubris. In the end the investment was saved, but it was a close-run thing.

With the third investment we come, at last, to a clear winner. The $1.47bn spent buying **American Express** stock has increased over 20-fold so far. When Buffett was 33 in 1964, he observed the strength of the American Express business model by sitting in a diner and noting the regular use of its card. In the mind of customers, it was a quality brand providing a unique service. He made a fortune for his investment partners in the 1960s by investing after Wall Street downgraded the stock following the salad oil scandal (volume one, investment eight).

In the 1990s, Buffett again observed similar franchise qualities at a time when Mr Market viewed the company with suspicion. It had been wasting money on adventures outside of the core business of charge cards and travellers' cheques. Apart from buying investment banks, brokerages and a Swiss private bank, it purchased a conference centre and, even more bizarrely, an art gallery. It was also under competitive threat from Mastercard and Visa. Buffett saw that underneath the rubble the high-quality economic franchise was intact with extremely loyal card members and travellers. He could visualise where the company could be ten years later if it went through a refocusing exercise conducted by managers he could trust.

The **Shoe Group** was disappointing but educational. Within this case study we have what Buffett called his "most gruesome error". The shoe and boot manufacturers **H. H. Brown** and **Lowell**, bought in 1991 and 1992, had specialist niche markets where they could charge prices giving good returns on capital. These businesses cost Berkshire only $161m and $46m respectively and were doing well when, in 1993, Buffett committed to buying the mid-market shoe manufacturer and retailer **Dexter** for $433m. Worse, the payment was in the form of 25,203 Berkshire shares, amounting to 2.14% of the equity. Today, those shares are worth $10bn. The value of the Dexter business given in return was zero within a few years.

One of the lessons from this episode is that investors must pay great attention to industry competitive dynamics. Mid-market shoes manufactured in America were subject to intense competition from developing country producers who had much lower costs; it was a commoditised industry. Quick action was needed from Dexter's managers to move production to low-cost places, but they were slow.

Post-mortems to advance the quality of thinking are a key part of Buffett's investment journey. Painful though it was to rake over the coals of the Dexter disaster, Buffett continued to remind himself about the logic-path he took that led to such a poor purchase decision.

The fifth investment, **Helzberg Diamond Shops** in 1995, is useful for illustrating Buffett's valuation method. This family business had 143 jewellery stores. Buffett could see a record of steady sales growth, high productivity per store, good returns on capital employed, excellent managers and an owner who loved the business and cared deeply about what would happen to his people and customers.

Barnett Helzberg, Jr. was attracted to the Berkshire fold, like many other founders/entrepreneurs, because he trusted Buffett to continue with the team he had assembled, to reinforce its unique culture with its focus on doing right by the customer. He didn't want a financial butcher carving up his family's creation and selling it piecemeal; "I didn't want my associates spitting on my grave," he said.

Buffett did not interfere with the business once acquired by Berkshire. He didn't look to combined Borsheims with Helzberg even though they sold similar products. This was because he had promised autonomy to each set of leaders and he wanted to preserve their distinctive cultures. Also, he liked the nuanced strategic focus and *esprit de corp* of each organisation.

But there was one major change implemented, which is a theme at Berkshire: Buffett and Munger kept a tight rein on capital allocation. Basically, Buffett becomes the 'bank' for each company. Leaders may only draw money from the bank for expansion purposes if more than a dollar of value will be created from each one taken. In the case of Helzberg, far from expanding, the number of stores has actually fallen over the last 20 years. The bank has received much from Helzberg rather than the other way around.

Another common theme: Buffett bought without conducting formal due diligence. He says that the character of the people is far more important than conventional due diligence. He asks if they are people of integrity, honesty, competence and rationality.

R.C. Willey is another purchase where the owner was most concerned that both his team and unique company ethos would be preserved after acquisition. Before selling, Bill Child – who had built R.C. Willey from a 600 sq ft store at the side of a dirt track into a furnishing empire with $257m in sales – spoke with Irv Blumkin, who had sold a majority stake in Nebraska Furniture Mart to Berkshire 12 years before in 1983 (volume two, investment three). Blumkin said Buffett had kept every promise he made, including autonomy, preservation of culture and long-term focus.

Bill Child feels honoured to be one of Buffett's key executives, and even today, aged 89, he works to build on his legacy at R.C. Willey, despite it being 100% owned by Berkshire and despite his enormous wealth.

He is determined to make Buffett proud, something he has in common with many key Berkshire leaders.

So far, this investment has returned to Berkshire five times its purchase price. And that was achieved without breaking the Mormon rule of not opening stores on a Sunday – a day when, in most cities, a fifth of furniture sales occur. At first, Buffett would not allow expansion outside of areas with significant Mormon populations. But that changed after Child volunteered to pay for land and the cost of the build himself and sell the store to Berkshire only if it was successful in the first six months. Despite being closed on Sundays, the R.C. Willey value proposition is so strong that R.C. Willey stores outsell competitors, even in places like Las Vegas.

The seventh investment, **FlightSafety International** – costing $1.5bn in 1996 – was also a purchase from the innovator, Al Ueltschi, who, at 78, wanted his creation to go to a good home. Also note that this is yet another example of an entrepreneur selling to Berkshire a business that concentrated on one segment of one industry, where there was a continuous effort to improve the product or service, putting ever greater distance between themselves and less focused competitors.

Al Ueltschi fell out of a biplane in 1940 when a poor pilot carried out a manoeuvre. With only 150 feet to go the canopy opened so violently it ripped his underwear, which was further ripped by the briar patch he landed in. A lesson hard learned: the importance of a well-trained pilot who you could trust in all circumstances.

In 1951, Ueltschi took out a $15,000 mortgage on his home to set up the company that would become the world leader in simulator training. By 1996, it had 175 simulators for 50 different aircrafts and annually trained over 50,000 pilots and maintenance technicians.

So far, Berkshire has received over $4bn from its investment and FlightSafety continues to reliably generate cash due to its dominant market position. Despite being a capital-intensive business, it can charge enough to regularly produce returns on capital over 20%.

Dairy Queen has thousands of ice cream and fast hot-food stores. Warren Buffett had been a loyal customer since his boyhood – he even took a teenage date to an Omaha Dairy Queen. In 1996, the company was producing income after tax of $34m. Investing $587.8m, Buffett was paying a hefty price-to-earnings ratio of over 17. But he thought there was a lot of potential to grow profits and make high returns on capital with its excellent managers at the helm and its collection of local monopolies in many small American towns. There was a great deal of affection and nostalgia for the local DQ. The business had a "high share of mind".

Investment nine, **NetJets**, made losses in the 11 years following Berkshire's purchase in 1998 for $725m, becoming Buffett's "number one worry". Its costs were far out of line with revenues as it pushed hard for market dominance. Cash haemorrhaged, and it would have gone bust had it not been for Berkshire's backing.

NetJets offers fractional ownership of an aircraft for busy executives, celebrities, or just wealthy people. In return for buying, say, one-eighth of a share, you are entitled to 100 hours flying time per year and can book your aircraft or a substitute with only a few hours' notice. Richard Santulli invented the concept as a way of avoiding the cost of owning an executive jet outright or paying expensive fees to travel in charter jets.

When Buffett became interested, the company had annual sales of around $1bn and was determined to remain the biggest in the business by far. The plan was to have such a blanketing of planes that customers were assured one would always be available regardless of where they are or where they want to fly. Revenue doubled in the first two years under Berkshire's ownership.

But growth was expensive, and Berkshire borrowed over $1bn to support the drive to stay ahead of rivals. At first Buffett was all in favour of investing to create a deep and dangerous moat for rivals to try and cross. But as losses mounted, he veered more to restraining capacity growth and focusing on profits. This worked, and annual profits of over $200m have been achieved pretty consistently since 2010.

Whether the years of profit make up for the earlier years of losses is still a moot point, given the opportunity cost of the billions committed to NetJets. But at least we investors learn that in some cases, in some industries, achieving market superiority can be very expensive. Dominance does not always lead to good profits; this depends on strategic dynamics, volume of customers willing to pay up and the size of the potential market.

The **General Re** chapter is a long one because it doesn't only deal with this company but explains the economics of the insurance business, how to value property and casualty insurers, the development of Berkshire Hathaway Primary insurance from its roots in National Indemnity, and Ajit Jain's creation of Berkshire's Reinsurance business.

The performances of Berkshire's four insurance groups – GEICO, General Re, BH Primary and BH Reinsurance – are examined in terms of underwriting profitability and amount of money held in floats.

Before the $22bn purchase of General Re, Buffett had access to about $7bn of float money available to be invested until insurance claims were made. Its acquisition more than trebled Berkshire's float, allowing Buffett to invest in interesting equities on a vast scale.

But there was a dreadful cost, because General Re made losses on underwriting in the first five years of ownership accumulating to $7.9bn. After the 9/11 Twin Towers attack in New York it would have gone to the wall but for Berkshire's financial strength. Buffett thought he had made a terrible mistake as he discovered that managers had for years under-priced insurance contracts and made large losses on derivative deals.

Later however, with new managers focused on profitable business rather than growth in volume of premiums, General Re became a jewel, with both underwriting profits and billions of float for Buffett to invest.

Who this book is for

This book is for investors who want to learn – or be prompted to bring again to the front of the mind – the vital rules for successful investment, through a series of fascinating investment case studies.

How the book is structured

It is arranged in ten case studies. You can dip in and read about particular deals that take your interest if you wish, but I would encourage you to read chronologically to achieve an understanding of how Warren Buffett developed as an investor.

Investment 1

WELLS FARGO

Summary of the deal

Deal	Wells Fargo
Time	Phase 1: buying period 1989–1996. Phase 2: buying period 2003–2015.
Price paid	Phase 1: $498m, average $68.3 per share (after subsequent splits: $3.41) Phase 2: $12.4bn, average $24.8 per share
Quantity	Phase 1: 8%–14.5% of common stock. Phase 1 and 2 combined: 3.3%–9.9% of common stock
Sale price – adjusted for splits	Phase 1: $12 –$28 Phase 2: $23–$65
Profit	Phase 1: At least 14-fold Phase 2: So small that it barely kept pace with inflation
Berkshire Hathaway in 1989	Share price: $4,700–$8,825 Book value: $4,927m Per share book value: $4,296

At the heart of this story is fear; a dread of what is in the black box of a bank. Most of the time Mr Market is gloriously insouciant about what banks are doing with all those billions of dollars deposited by millions of families just so long as the bank reports rising quarterly earnings. He knows some of the money is lent out to people to buy houses and some goes to small businesses in the neighbourhood, but as for the rest of it, and how much risk is taken on, Mr Market is blissfully unaware.

Mr Market's logic is that if the big machine called a bank is producing good dividends, then the managers must have a firm grasp of risk, with sound diversification, thoroughly thought through lending decisions and stacks of collateral backing every loan. Certainly, the bank bosses always sound confident and competent, so that comforts him.

But then recession strikes. The market value of assets used as collateral plunge; indebted companies find orders drying up and they are no longer generating enough cash to meet their loan obligations. Mr Market is now scared. And when Mr Market is scared, he sells those nasty risky things called bank shares. And he can do it indiscriminately.

When recession lights up the corners of some black boxes the whole world can see the horror show. The managers have been lending to people who were on the edge even in the good times. Now that recession and redundancies are here, hundreds of thousands cannot service their mortgages. Bank underwriters were so desperate to lend to the 'companies of tomorrow' that they went easy on loan covenants, often not requiring sound collateral at all, or a trading history, or even proven cash-flow generation.

Oh, and then there is lending by way of purchasing financial instruments in the market, whether that be commercial paper, leveraged loans, high-yield bonds or some whizz-bang innovation in the derivative markets. Who knows what their true worth is – in recessions it's often zero.

Having looked into the dark recesses of some black boxes and been shocked to the core, Mr Market starts to fear that every bank is the same. An entire sector is sold off, share prices collapse.

In this moment of panic, in steps the true investor. That is, those people who ignore Mr Market's emotions and coolly assess the facts of each company. There will be no tarring with the same brush here.

Each company examined by a value investor is to be treated as though it was his/her own family business and thought is directed towards assessing its long-term viability, its potential to generate cash for shareholders decades into the future.

For that assessment, the value investor needs to make a judgement on the strategic position of the firm – does it have competitive advantages permitting high rates of return on capital employed?

Judgement is also required about the qualities of its managers – are they both competent and shareholder oriented?

And reassurance is needed about the bank's operational and financial stability both in the short and the long run – sure, it might have some temporary difficulties, but is there a reasonable prospect of lowering potential for financial distress in the medium term?

When recession struck in 1990, Warren Buffett and Charlie Munger were there to observe both Mr Market's panic regarding the banking sector and the strengths of Wells Fargo relative to other banks.

Here are some reasons for worry

I'm going to provide a very simplified version of what a bank is and how it is structured. It's not perfect but will serve to illustrate why Mr Market was correct to fear for the future of many banks in 1989–90.

Imagine you have two and half million dollars – I know, it's good to dream – and you decide to use that to start a bank. The corporation is registered with $2.5m shares of common stock as its equity capital. The magic of banks is that most of the money for lending comes not from shareholders but from other people. As a bank owner you can make profit by paying low/no interest on money attracted to cheque or deposit accounts, and then lend that money out to individuals or companies at higher rates.

Let's imagine that you establish 455 branches throughout California and a few other states. The money flows in at a great rate, and your branch managers get busy attracting families and firms to borrow from the bank. By the end of the year, you have drawn in $46.5m of deposits and lent out $49m.

On the $49m 'assets' the bank is, on average, earning such a high interest rate that for every dollar of loan each year it receives 5c more than what has to be paid in interest to attract that dollar as a deposit. That is, the 'net interest margin' is 5%.

If you were earning 5c only on each of your original $2.5m, that would amount to only $0.125m each year. But this is where the beauty of a bank's leverage comes in. You are not earning 5% of $2.5m, but 5% on $49m, i.e., $2.45m.

So, on your original capital of $2.5m you receive annually $2.45m, almost a 100% return per year. But we haven't yet taken into account the cost of 19,500 staff and maintaining all those buildings, etc. After doing that we find that the net income as a percentage of common stockholder equity is 24.49%, i.e., about $0.6m.

That's all fine in the good times when California is growing, house prices are rising and companies booming. But what if recession strikes and, say, 8% of the loans you have made turn sour – you are simply not going to be repaid on that 8%. That is a $3.9m hole blown in your accounts.

You now owe depositors $46.5m but your assets are only $49m – $3.9m = $45.1m. Rumours circulate about the soundness of your bank. Your customers can see what is happening to house prices in California and to businesses in their neighbourhood. The writing is on the wall. Your bank does not have enough money to pay back all those obligations in cheque/deposit accounts.

"I know," thinks a customer, "I'll get to the bank branch this afternoon and take my money out before other people realise just how bad it is." The bank holds some money in cash and liquid resources and so can repay the first few thousand customers who turn up wanting to withdraw. But most of the money is lent out on illiquid terms to build factories, offices, trading businesses, etc. These borrowers cannot, at the drop of a hat, return the money.

If the feeling that depositors may not be able to retrieve their funds unless they act very quickly grows, there will be a rush by millions to demand their money, i.e., a 'run on the bank'.

Obviously, the bank cannot satisfy them all – it has no choice but to close. This was happening (in approximate terms) in America in the early 1990s and there was much fear that Wells Fargo would be next.

The Wells Fargo case

The numbers in millions I used above are pretty much the real numbers, but you need to convert the millions to billions for Wells Fargo in 1990. It had lent out $49bn, and owed depositors and others $46.5bn. Common stockholders' equity was about $2.5bn. It had 455 branches, 19,500 staff and had made around 5% net interest margin in the late 1980s and in 1990. The return on common stockholders' equity was about 24%.

But it was vulnerable. Its lending included $14bn lent to commercial businesses and farmers; $4bn for real estate construction of offices, shopping centres, apartments, etc; $15bn for real estate mortgages (e.g., 70,000 Californian families); $9bn on consumer finance, e.g., credit cards; and another $1bn or so on other types of lending.

Imagine if you will – and many people did in 1990 – that many of the construction loans it had made were not going to be repaid because the developer could no longer make a profit by completing the building and chose bankruptcy instead, or that bad debt on credit cards rose as people were made redundant. You can see that it wouldn't take a large proportion of these borrowers to renege on their contracts for Wells Fargo's equity buffer to be used up.

Wells Fargo going down

In 1989, Wells Fargo shares had reached $87.40 as it reported fast growth in lending and exuded confidence about the future. But by the third quarter of 1990 it touched a low of $42.75 as troubles at many banks became apparent – the black boxes were exposed in all their ugliness.

Investors in Californian banks had recently witnessed the banking crisis over in Texas, resulting in 349 bank failures. The late 1970s/early 1980s boom in oil and gas prices and output had encouraged banks to lend to resource companies, real estate developers and families. Buildings went up everywhere, until, in 1987, it was apparent that supply far outstripped demand, e.g., in Dallas, Austin, Houston and San Antonio office vacancy rates were around 25–30%. The oil price had fallen but property developments had continued. Once the music stopped, unable to obtain cash, overstretched construction companies and developers couldn't repay loans.

There was also a boom in residential and commercial real estate markets in New England during the 1980s, fuelled by a strong regional economy. But the boom eventually led to over-building and irrational speculation in property assets. Late in the decade, boom turned to bust taking down dozens of banks.

The banking bears were out looking for the next banking-crisis geography, and California was a prime candidate. Between 1982 and July 1990 the 'Reagan boom' was particularly strong in California, with rapidly growing companies, real estate prices and lending. But in the late 1980s interest rates rose, and the Iraqi invasion of Kuwait lifted oil prices and decreased consumer confidence so much so that the USA entered recession.

California was particularly hard hit as the aerospace and defence sectors cut back sharply and commercial construction declined very quickly – they had overbuilt. Unemployment rose by over half a million and real estate values fell. Office vacancy rates were headed towards 18% in Los Angeles. There was massive shorting of the shares of Wells Fargo and other banks in 1990.

What Warren saw in 1990

Warren Buffett started building his holding in Wells Fargo in 1989, but it wasn't until October 1990 that the stake grew so large that he announced Berkshire Hathaway held 5m shares – almost 10% of its common stock – making it the largest shareholder.

What was it that made Buffett go against the crowd and spend $289m on a bank facing a recession in its home market?

A few months after the announcement, Buffett's letter in BH's 1990 annual report set out some of his thinking. Wells Fargo was "a superbly-managed, high-return banking operation". He then immediately highlights the dangers of investing in this sector. "The banking business is no favourite of ours. When assets are twenty times equity – a common ratio in this industry – mistakes that involve only a small portion of assets can destroy a major portion of equity. And mistakes have been the rule rather than the exception at many major banks."

He wrote this in the midst of a humdinger of a recession. But he laid the blame for these failures squarely at the door of bank managers who follow the "institutional imperative", mindlessly copying the behaviour of other bankers, even if that behaviour is foolish. In the *Financial Times Guide to Banking,* I warn readers not to think bank lending decisions as entirely rational. Many bankers seem to follow fashions as they come and go. They have a habit of rushing to one type of lending one year, say, house mortgages, which then become underpriced and banks become over-exposed there, and then, in another year, hurling themselves at another sector, say, warehouse builders or farmers. Buffett gloomily concluded that bankers, having "played follow-the-leader with lemming-like zeal; now they are experiencing a lemming-like fate".[1]

He noted that leverage of 20:1 had the effect of magnifying managerial strengths and weaknesses, with the implication that most banks in 1990 were beyond the pale and not to be touched, even if they appeared cheap. But Wells Fargo was different. It was different in a way that you'll not find on a spreadsheet or a database. The advantage lay in the fuzzy world of the qualities of people: "With Wells Fargo, we think we have obtained the best managers in the business, Carl Reichardt and Paul Hazen."[2]

In the banking sphere, these two were considered by Buffett to be as great as the combination of Tom Murphy and Dan Burke at Capital Cities/ABC in media. Three characteristics were possessed by both sets of partners:

- As a pair, they were stronger than the sum of the parts because each partner understood, trusted and admired the other.
- They were strict on costs – e.g., not having a larger staff than absolutely necessary – but they paid talented team members very well.
- They stayed within their respective circles of competence and let "their abilities, not their egos, determine what they attempt. (Thomas J. Watson, Sr. of IBM followed the same rule: 'I'm no genius', he said. 'I'm smart in spots – but I stay around those spots.')"[3]

Berkshire Hathaway purchased its 10% holding in Wells Fargo at a price about five times recent earnings after tax. Buffett pointed out, to perhaps sceptical recession-battered BH shareholders, that the bank had been earning more than 20% on equity, implying that with such fine managers it would again achieve such returns once the recession was over.

But he wanted to prepare BH shareholders for the possibility that good times might not prevail. He said ownership of a bank "was far from riskless" and went on to list the hits a Californian bank might have to take, including a major earthquake wreaking havoc on borrowers; a business recession or financial panic so severe it would imperil every highly-leveraged institution, no matter how intelligently run; and of course the risk that "West Coast real estate values will tumble because of overbuilding and deliver huge losses to banks that have financed the expansion. Because it is a leading real estate lender, Wells Fargo is thought to be particularly vulnerable."[4]

Buffett considered the likelihood of earthquake and an exceptionally severe recession or panic to be low. But the threat from tumbling real estate was much more likely. That led to the next question: how much of an impact would the anticipated downturn have on Wells Fargo's profits and balance sheet?

In his answer, Buffett pointed out that Wells Fargo produced well over $1bn pre-tax profits even after allowing $300m for loan losses. He reasoned that, even if one-tenth of all $48bn of the bank's loans were in trouble in 1991 with missed payments etc., as long as (after some forbearance on timing of payments and some nurturing of borrowers) no more than 30% of this was ultimately lost by the bank, it would