



A Finger on the Pulse of Berkshire Hathaway and Warren Buffett

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Throughout the spring, the snowballing financial scandal at insurance giant American International Group has put the spotlight on the firm's partner in the improper deal, General Re Corp. Could the damage extend to Gen Re's owner, Berkshire Hathaway Inc. and its legendary chief, Warren Buffett?

"There clearly is some damage to General Re. And that, by definition, is damage to Berkshire," said [Neil A. Doherty](#), professor of insurance and risk management at Wharton. "I'm not sure how much this will filter through to Berkshire. The issue really is how distant Warren Buffett is from this [scandal], and I'm not seeing direct connections there."

The questions about Gen Re come on top of another that gets larger every year: Can Berkshire continue to deliver outsized returns to shareholders after 74-year-old Buffett, who has run the company for four decades, passes from the scene? Since 1965, Berkshire's average annual returns have been about double those of the Standard & Poor's 500.

Gen Re, a reinsurance giant with worldwide operations, is among Berkshire's largest units. In 2000, it provided a \$500 million finite insurance policy that AIG used to improperly dress up its financial statements to bolster AIG's stock price. The scandal led AIG directors to force out their chairman and chief executive, Maurice Greenberg, and AIG has since reported a number of other accounting improprieties.

Greenberg, according to AIG, was directly involved in the finite-insurance deal with Gen Re. But it is not clear whether Gen Re executives knew that AIG improperly booked the deal, which in itself was legal. AIG had called the contract an insurance policy when it was in fact a loan. By mid-May, one Gen Re executive had been notified by regulators that he could face criminal charges, and Gen Re put him and a second executive on leave.

Buffett has been interviewed by regulators, but he has been described as a cooperating witness rather than a target of the investigation. In a March 29 statement, Berkshire said that "Mr. Buffett was not briefed on how the transactions were to be structured or on any improper use or purpose of the transactions."

Since the end of February, when the seriousness of the AIG scandal began to become apparent, Berkshire's stock has fallen about 8%, compared to a 1.6% drop in the Standard & Poor's 500.

"I think the conclusion depends on facts not in evidence, as they would say in court," said [J. David Cummins](#), professor of insurance and risk management at Wharton. "We have no idea how widespread this is.... If it's only the single transaction, I don't think it's going to tank the company or put a dent in it. However, if it turns out to be only the tip of the iceberg, that could be a problem."

Wharton finance professor [Jeremy Siegel](#), a friend of Buffett's, added: "Gen Re is an important part of Berkshire. I think Warren would be the first to admit that he didn't know all the problems of Gen Re when he bought it [in 1998].... There clearly is no ethical issue involving him."



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Investing the Float

In 40 years, Buffett has converted Berkshire from a small New England textile manufacturer to a mammoth holding company. Among the publicly traded companies in its portfolio, the largest stakes in market value are in American Express (\$8.5 billion), Coca-Cola (\$8.3 billion) and Gillette (\$4.3 billion). Its largest stakes as a percentage of shares outstanding are in The Washington Post (18.1%), Moody's (16.2%) and White Mountains Insurance (16%). Altogether, Berkshire's holdings in the publicly traded companies were worth \$37.7 billion at the end of 2004, according to the company's annual report.

In addition, Berkshire has a number of wholly owned subsidiaries. That includes a number of insurers, whose size is measured by "float" -- the money on hand from insurance premiums received from customers and not yet paid out for claims. Gen Re is the largest of the insurance subsidiaries, with a \$23.6 billion float. Next are Berkshire Hathaway Reinsurance (\$13.9 billion) and Geico Insurance (\$5.3 billion). Total float for these and other insurance operations is about \$46 billion.

Reinsurers provide policies to other insurance companies, allowing them to cover potential claims that would be too large to pay on their own. Insurers of all types can make underwriting profits whenever the premiums exceed claims paid. But, typically, the lion's share of insurance-company profits comes from investing the float. Berkshire uses the float to invest in stocks and to buy whole companies.

Gen Re has not been the most successful Berkshire unit. Underwriting profit was a scant \$3 million last year, compared to \$970 million and \$417 million at the smaller Geico and Berkshire Hathaway Reinsurance units.

But in his annual letter to shareholders this spring, Buffett blamed Gen Re's poor performance on bad decisions the company made before its current chairman and CEO, Joseph Brandon, took over three years ago. "At General Re, Joe Brandon has restored the long-admired culture of underwriting discipline that, for a time, had lost its way," Buffett wrote. "The excellent results he realized in 2004 on current business, however, were offset by adverse developments from the years before he took the helm."

The finite insurance deal with AIG was done under Brandon's predecessor. Any repercussions from that deal therefore do not seem likely to up-end Gen Re's current management. Fines or other financial penalties are not likely to do lasting damage, either, as Berkshire is sitting on \$43 billion in cash.

But could Gen Re have been involved in other improper activities? "General Re is known as a pretty conservative operation," said Cummins, adding that unlike AIG, which has faced numerous questions about accounting practices and other matters over the years, Gen Re has a clean track record. "I would be mildly surprised if General Re had been into this in a major, major way. If this is the only involvement of General Re, I just don't see it as being a big deal. I think it will blow over." Siegel noted that Gen Re's business problems, mainly from writing policies that were too risky, probably turned out to be bigger than Buffett expected when he bought the company in 1998. But, he added, "I think he's got a better crew now."

Also, it is not unusual for a new Berkshire acquisition to have some troubles at the start. Buffett hunts for companies he can get at bargain prices, usually because they are beaten down by problems he views as soluble. After Berkshire picked up National Indemnity Company in 1980, for example, it suffered losses in four of the next five years, according to Berkshire's 2004 annual report. That was followed by 16 years of handsome profits. The only loss since 1984 was in 2001, when many insurers were hammered. "Indeed, had we not made this acquisition, Berkshire would be lucky to be worth half what it is today," Buffett said in his recent annual letter to shareholders.

Though Buffett is often described as a brilliant stock picker, publicly traded stocks now constitute less than half of Berkshire's net worth. And he is not an active stock trader; he generally buys only stocks he

hopes to hold forever.

In recent years, Buffett also has become a big investor in currency markets. At the end of 2004, Berkshire owned \$21.4 billion in foreign exchange contracts involving 12 currencies. He strongly believes that the U.S. current accounts deficit will cause the dollar to fall. Although the dollar climbed slightly last year, causing a \$310 million loss on these bets, Buffet said he would stick with his bets against the dollar.

"The Buffett Way" of Investing

At 74, Buffett says he is in excellent health and has no plans to retire. Nor has he named a successor. But if he did leave the company, what would happen to it? Buffett is universally viewed as the key to Berkshire's fine performance. "He's obviously a very bright man," Siegel said. "He looks at things very rationally. He doesn't like to get his emotions involved."

While that sounds like a sensible practice anyone could emulate, it's very difficult to keep excitement, worry and other emotions from affecting decisions, Siegel added. Many books have been written about "The Buffett Way" of investing. But like most people at the top of their fields, Buffett has a talent that cannot be bottled, Siegel noted, and his departure would inevitably be something of a blow. He has no obvious successor: His long-time partner, Charlie Munger, is older.

On the other hand, many parts of Berkshire may be able to chug along quite well without Buffett. Although he is a hands-on investor, choosing companies and stocks very carefully, he is not a hands-on manager. His style is to put good executives into place, or keep the good ones he gets when he buys a company. He then leaves them free to manage with little interference from his famously lean corporate headquarters.

His departure could bring an end to the string of brilliant acquisitions. But not much is going on with that part of the company, anyway. "My hope was to make several multi-billion dollar acquisitions that would add new and significant streams of earnings to the many we already have," he said in his shareholders letter. "But I struck out. Additionally, I found very few attractive securities to buy. Berkshire therefore ended the year with \$43 billion in cash equivalents."

While he promised to keep looking, he also said stock returns are likely to be smaller in the future than they were in the past. Hence, investors cannot count on dramatic gains in Berkshire even if Buffett stays on the job for some time.

Neither, however, should they expect Buffett's advancing age to have much effect on the share price. "Everyone knows he's not going to live forever," Siegel said. "That's built into the price.... The market is thinking, maybe he's got five to 10 years.... If we knew that Buffett was going to live forever, maybe the stock would be 10% higher."

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