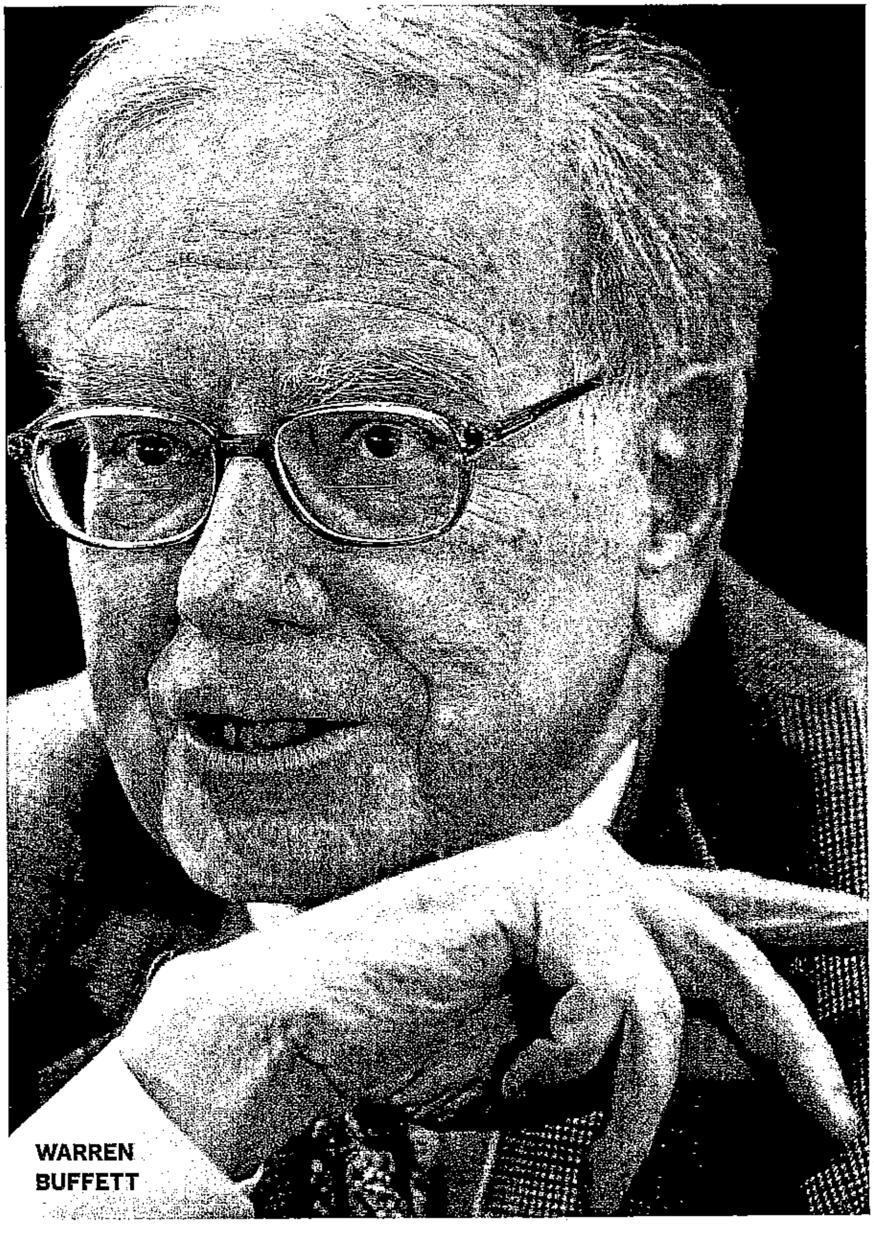
Cut Your Gains!

In his 2006 letter to Berkshire Hathaway shareholders, **Warren Buffett** explains how costly it can be to let advisors come between you and your money.


ERIC FRANCIS—BLOOMBERG NEWS/LANDOV

WARREN BUFFETT

Warren Buffett often uses his annual report to comment on a subject he believes of importance to today's markets. Here, from the report just published (available at www.berkshirehathaway.com), is an allegory about "How to Minimize Investment Returns."

IT'S BEEN AN EASY MATTER for Berkshire and other owners of American equities to prosper over the years. Between Dec. 31, 1899, and Dec. 31, 1999, to give a really long-term example, the Dow rose from 66 to 11,497. (Guess what annual growth rate is required to produce this result; the surprising answer is at the end of this piece.) This huge rise came about for a simple reason: Over the century, American businesses did extraordinarily well and investors rode the wave of their prosperity. Businesses continue to do well. But now shareholders, through a series of self-inflicted wounds, are in a major way cutting the returns they will realize from their investments.

The explanation of how this is happening begins with a fundamental truth: With unimportant exceptions, such as bankruptcies in which some of a company's losses are borne by creditors, *the most that owners in aggregate can earn between now and Judgment Day is what their businesses in aggregate earn.* True, by buying and selling that is clever or lucky, investor A may take more than his share of the pie at the expense of investor B. And, yes, all investors *feel* richer when stocks soar. But an owner can exit only by having someone take his place. If one investor sells high, another must buy high. For owners as a whole, there is simply no magic—no shower of money from outer space—that will enable them to extract wealth from their companies beyond that created by the companies themselves.

Indeed, owners must earn less than their businesses earn because of "frictional" costs. And that's my point: These costs are now being incurred in amounts that will cause shareholders to earn *far* less than they historically have.

To understand how this toll has ballooned, imagine for a moment that all American corporations are, and always will be, owned by a single family. We'll call them the Gotrocks. After paying taxes on dividends, this family—generation after generation—becomes richer by the aggregate amount earned by its companies. Today that amount is about $700 billion annually. Naturally, the family spends some of these dollars. But the portion it saves steadily compounds for its benefit. In the Gotrocks household everyone grows wealthier at the same pace, and all is harmonious.

But let's now assume that a few fast-talking Helpers approach the family and persuade each of its members to try to outsmart his relatives by buying certain of their holdings and selling them certain others. The Helpers—for a fee, of course—obligingly agree to handle these transactions. The Gotrocks still own all of corporate America; the trades just rearrange who owns what. So the family's annual gain in wealth diminishes, equaling the earnings of American business minus commissions paid. The more that family members trade, the smaller their share of the pie and the larger the slice received by the Helpers. This fact is not lost upon these broker-Helpers: Activity is their friend, and in a wide variety of ways, they urge it on.

HEADS, THE HELPER TAKES MUCH OF THE WINNINGS. TAILS, THE GOTROCKS LOSE AND PAY DEARLY.

After a while, most of the family members realize that they are not doing so well at this new "beat my brother" game. Enter another set of Helpers. These newcomers explain to each member of the Gotrocks clan that by himself he'll never outsmart the rest of the family. The suggested cure: "Hire a manager—yes, us—and get the job done professionally." These manager-Helpers continue to use the broker-Helpers to execute trades; the managers may even increase their activity so as to permit the brokers to prosper still more. Overall, a bigger slice of the pie now goes to the two classes of Helpers.

The family's disappointment grows. Each of its members is now employing professionals. Yet overall, the group's finances have taken a turn for the worse. The solution? More help, of course.

It arrives in the form of financial planners and institutional consultants, who weigh in to advise the Gotrocks on selecting manager-Helpers. The befuddled family welcomes this assistance. By now its members know they can pick neither the right stocks nor the right stock pickers. Why, one might ask, should they expect success in picking the right consultant? But this question does not occur to the Gotrocks, and the consultant-Helpers certainly don't suggest it to them.

The Gotrocks, now supporting three classes of expensive Helpers, find that their results get worse, and they sink into despair. But just as hope seems lost, a fourth group—we'll call them the hyper-Helpers—appears. These friendly folk explain to the Gotrocks that their unsatisfactory results are occurring because the existing Helpers—brokers, managers, consultants—are not sufficiently motivated and are simply going through the motions. "What," the new Helpers ask, "can you expect from such a bunch of zombies?"

The new arrivals offer a breathtakingly simple solution: *Pay more money.* Brimming

A LOOK AT BERKSHIRE'S BIGGEST HOLDINGS

Buffett runs Berkshire Hathaway's $47 billion stock portfolio by the principles he preaches. He trades very little, which means the Helpers don't get a big slice of his profits. Below, Berkshire's 12 largest investments.

Stock / ticker	Began buying in	Percentage of company owned[1]	Cost[1] in millions	Market value[1] in millions
American Express AXP	1991	12.2%	$1,287	$7,802
Ameriprise Financial[2] AMP	N.A.	12.1%	$183	$1,243
Anheuser-Busch BUD	2004	5.6%	$2,133	$1,884
Coca-Cola KO	1988	8.4%	$1,299	$8,062
M&T Bank MTB	1991	6.0%	$103	$732
Moody's MCO	1999	16.2%	$499	$2,948
PetroChina PTR	2002	1.3%	$488	$1,915
Procter & Gamble[3] PG	N.A.	3.0%	$940	$5,788
Wal-Mart WMT	2005	0.5%	$944	$933
Washington Post WPO	1973	18.0%	$11	$1,322
Wells Fargo WFC	1989	5.7%	$2,754	$5,975
White Mountains Ins. WTM	2000	16.0%	$369	$963

N.A. Not applicable. [1]As of Dec. 31, 2005. [2]Spun off from American Express in 2005. [3]Acquired when Procter & Gamble purchased Gillette in 2005. Berkshire first bought Gillette shares in 1989.

SOURCE: BERKSHIRE HATHAWAY

NATI HARNIK—AP

COUNTING TRICKS Next to investing, the game Buffett likes best is bridge.

with self-confidence, the hyper-Helpers assert that huge contingent payments—in addition to stiff fixed fees—are what each family member must fork over in order to *really* outmaneuver his relatives.

The more observant members of the family see that some of the hyper-Helpers are really just manager-Helpers wearing new uniforms, bearing sewn-on sexy names like HEDGE FUND or PRIVATE EQUITY. The new Helpers, however, assure the Gotrocks that this change of clothing is all-important, bestowing on its wearers magical powers similar to those acquired by mild-mannered Clark Kent when he changed into his Superman costume. Calmed by this explanation, the family decides to pay up.

And that's where we are today: A record portion of the earnings that would go in their entirety to owners—if they all just stayed in their rocking chairs—is now going to a swelling army of Helpers. Particularly expensive is the recent pandemic of profit arrangements under which Helpers receive large portions of the winnings when they are smart or lucky, and leave family members with all the losses—and large fixed fees to boot—when the Helpers are dumb or unlucky (or occasionally crooked).

A sufficient number of arrangements like this—heads, the Helper takes much of the winnings; tails, the Gotrocks lose and pay dearly for the privilege of doing so—may make it more accurate to call the family the Hadrocks. Today, in fact, the family's frictional costs of all sorts may well amount to 20% of the earnings of American business. In other words, the burden of paying Helpers may cause American equity investors, overall, to earn only 80% or so of what they would earn if they just sat still and listened to no one.

Long ago, Sir Isaac Newton gave us three laws of motion, which were the work of genius. But Sir Isaac's talents didn't extend to investing: He lost a bundle in the South Sea Bubble, explaining later, "I can calculate the movement of the stars, but not the madness of men." If he had not been traumatized by this loss, Sir Isaac might well have gone on to discover the fourth law of motion: *For investors as a whole, returns decrease as motion increases.*

HERE'S THE ANSWER to the question posed at the beginning of this piece: To get very specific, the Dow increased from 65.73 to 11,497.12 in the 20th century, and that amounts to a gain of 5.3% compounded annually. (Investors would also have received dividends, of course.) To achieve an equal rate of gain in the 21st century, the Dow will have to rise by Dec. 31, 2099, to—brace yourself—precisely 2,011,011.23. But I'm willing to settle for 2,000,000; six years into this century, the Dow has gained not at all. F