7258 Highlights from the Berkshire Hathaway 2015 Letter

These are direct quotes taken from the Berkshire Hathaway 2015 Letter to Shareholders. There is no commentary from 7258 below. We found them to be interesting snippets on Berkshire, life, investing, economics, our world and the environment. Enjoy!!

That leaves us with our Kraft Heinz holding carried on our balance sheet at a value many billions above our cost and many billions below its market value, an outcome only an accountant could love.

If you want to guarantee yourself a lifetime of misery, be sure to marry someone with the intent of changing their behavior.

Berkshire, however, will join only with partners making friendly acquisitions. To be sure, certain hostile offers are justified: Some CEOs forget that it is shareholders for whom they should be working, while other managers are woefully inept. In either case, directors may be blind to the problem or simply reluctant to make the change required. That's when new faces are needed. We, though, will leave these "opportunities" for others. At Berkshire, we go only where we are welcome.

Our flexibility in capital allocation – our willingness to invest large sums passively in non-controlled businesses – gives us a significant edge over companies that limit themselves to acquisitions they will operate. Woody Allen once explained that the advantage of being bi-sexual is that it doubles your chance of finding a date on Saturday night. In like manner – well, not exactly like manner – our appetite for either operating businesses or passive investments doubles *our* chances of finding sensible uses for Berkshire's endless gusher of cash. Beyond that, having a huge portfolio of marketable securities gives us a stockpile of funds that can be tapped when an elephant-sized acquisition is offered to us.

America's population is growing about .8% per year (.5% from births minus deaths and .3% from net migration). Thus 2% of *overall* growth produces about 1.2% of *per capita* growth. That may not sound impressive. But in a single generation of, say, 25 years, that rate of growth leads to a gain of 34.4% in *real* GDP per capita. (Compounding's effects produce the excess over the percentage that would result by simply multiplying 25 x 1.2%.) In turn, that 34.4% gain will produce a staggering $19,000 increase in *real GDP per capita* for the next generation. Were that to be distributed equally, the gain would be $76,000 annually for a family of four. Today's politicians need not shed tears for tomorrow's children.

Disciplined risk evaluation is the daily focus of *all* of our insurance managers, who know that while float is valuable, its benefits can be drowned by poor underwriting results. All insurers give that message lip service. At Berkshire it is a religion, Old Testament style.

At bottom, a sound insurance operation needs to adhere to four disciplines. It must (1) understand *all* exposures that might cause a policy to incur losses; (2) conservatively assess the likelihood of any exposure actually causing a loss and the probable cost if it does; (3) set a premium that, on average, will deliver a profit after both prospective loss costs and operating expenses are covered; and (4) be willing to walk away if the appropriate premium can't be obtained. Many insurers pass the first three tests and flunk the fourth. They simply can't turn their back on business that is being eagerly written by their competitors. That old line, "The other guy is doing it, so we must as well," spells trouble in any business, but in none more so than insurance.

I suggest that you ignore a portion of GAAP amortization costs. But it is with some trepidation that I do that, knowing that it has become common for managers to tell their owners to ignore certain expense items that are all too real. "Stock-based compensation" is the most egregious example. The very name says it all: "compensation." If compensation isn't an expense, what is it? And, if real and recurring expenses don't belong in the calculation of earnings, where in the world do they belong? Wall Street analysts often play their part in this charade, too, parroting the phony, compensation-ignoring "earnings" figures fed them by managements. Maybe the offending analysts don't know any better. Or maybe they fear losing "access" to management. Or maybe they are cynical, telling themselves that since everyone else is playing the game, why shouldn't they go along with it. Whatever their reasoning, these analysts are guilty of propagating misleading numbers that can deceive investors.

Depreciation charges are a more complicated subject but are almost always true costs. Certainly they are at Berkshire. I wish we could keep our businesses competitive while spending less than our depreciation charge, but in 51 years I've yet to figure out how to do so. Indeed, the depreciation charge we record in our railroad business falls far short of the capital outlays needed to merely keep the railroad running properly, a mismatch that leads to GAAP earnings that are higher than true economic earnings. (This overstatement of earnings exists at all railroads.) When CEOs or investment bankers tout pre-depreciation figures such as EBITDA as a valuation guide, watch their noses lengthen while they speak.

A few, however – these are serious mistakes I made in my job of capital allocation – have very poor returns. In most of these cases, I was wrong in my evaluation of the economic dynamics of the company or the industry in which it operates, and we are now paying the price for my misjudgments. At other times, I stumbled in evaluating either the fidelity or the ability of incumbent managers or ones I later appointed. I will commit more errors; you can count on that. If we luck out, they will occur at our smaller operations.

There is no question that reckless practices in home lending played a major role in bringing on the financial panic of 2008, which in turn led to the Great Recession. In the years preceding the meltdown, a destructive and often corrupt pattern of mortgage creation flourished whereby (1) an originator in, say, California would make loans and (2) promptly sell them to an investment or commercial bank in, say, New York, which would package many mortgages to serve as collateral for a dizzyingly complicated array of mortgage-backed securities to be (3) sold to unwitting institutions around the world. As if these sins weren't sufficient to create an unholy mess, imaginative investment bankers sometimes concocted a second layer of sliced-up financing whose value depended on the junkier portions of primary offerings. (When Wall Street gets "innovative," watch out!) While that was going on, I described this "doubling-up" practice as requiring an investor to read tens of thousands of pages of mind-numbing prose to evaluate a single security being offered. Both the originator and the packager of these financings had no skin in the game and were driven by volume and mark-ups. Many housing borrowers joined the party as well, blatantly lying on their loan applications while mortgage originators looked the other way. Naturally, the gamiest credits generated the most profits. Smooth Wall Street salesmen garnered millions annually by manufacturing products that their customers were unable to understand. (It's also questionable as to whether the major rating agencies were capable of evaluating the more complex structures. But rate them they did.)

It's easy to look back over the 115-year span and realize how extraordinarily beneficial agricultural innovations have been – not just for farmers but, more broadly, for our entire society. We would not have anything close to the America we now know had we stifled those improvements in productivity. (It was fortunate that horses couldn't vote.) On a day-to-day basis, however, talk of the "greater good" must have rung hollow to farm hands who lost their jobs to machines that performed routine tasks far more efficiently than humans ever could.

Though the early bird gets the worm, the second mouse gets the cheese.

The productivity gains that I've just spelled out – and countless others that have been achieved in America – have delivered awesome benefits to society. That's the reason our citizens, as a whole, have enjoyed – and will continue to enjoy – major gains in the goods and services they receive. To this thought there are offsets. First, the productivity gains achieved in recent years have largely benefitted the wealthy. Second, productivity gains frequently cause upheaval: Both capital and labor can pay a terrible price when innovation or new efficiencies upend their worlds. We need shed no tears for the capitalists (whether they be private owners or an army of public shareholders). It's their job to take care of themselves. When large rewards can flow to investors from good decisions, these parties should not be spared the losses produced by *wrong* choices.

There is, however, one clear, present and enduring danger to Berkshire against which Charlie and I are powerless. That threat to Berkshire is also the major threat our citizenry faces: a "successful" (as defined by the aggressor) cyber, biological, nuclear or chemical attack on the United States. That is a risk Berkshire shares with *all* of American business. The probability of such mass destruction in any given year is likely very small. It's been more than 70 years since I delivered a Washington Post newspaper headlining the fact that the United States had dropped the first atomic bomb. Subsequently, we've had a few close calls but avoided catastrophic destruction. We can thank our government – and luck! – for this result. Nevertheless, what's a small probability in a short period approaches certainty in the longer run. (If there is only one chance in thirty of an event occurring in a given year, the likelihood of it occurring at least once in a century is 96.6%.) The added bad news is that there will forever be people and organizations and perhaps even nations that would like to inflict maximum damage on our country. Their means of doing so have increased exponentially during my lifetime. "Innovation" has its dark side. There is no way for American corporations or their investors to shed this risk. If an event occurs in the U.S. that leads to mass devastation, the value of all equity investments will almost certainly be decimated. No one knows what "the day after" will look like. I think, however, that Einstein's 1949 appraisal remains apt: "I know not with what weapons World War III will be fought, but World War IV will be fought with sticks and stones."

It seems highly likely to me that climate change poses a major problem for the planet. I say "highly likely" rather than "certain" because I have no scientific aptitude and remember well the dire predictions of most "experts" about Y2K. It would be foolish, however, for me or anyone to demand 100% proof of huge forthcoming damage to the world if that outcome seemed at all possible and if prompt action had even a small chance of thwarting the danger. This issue bears a similarity to Pascal's Wager on the Existence of God. Pascal, it may be recalled, argued that if there were only a tiny probability that God truly existed, it made sense to behave as if He did because the rewards could be infinite whereas the lack of belief risked eternal misery. Likewise, if there is only a 1% chance the planet is heading toward a truly major disaster and delay means passing a point of no return, inaction now is foolhardy. Call this Noah's Law: If an ark may be essential for *survival*, begin building it today, no matter how cloudless the skies appear.