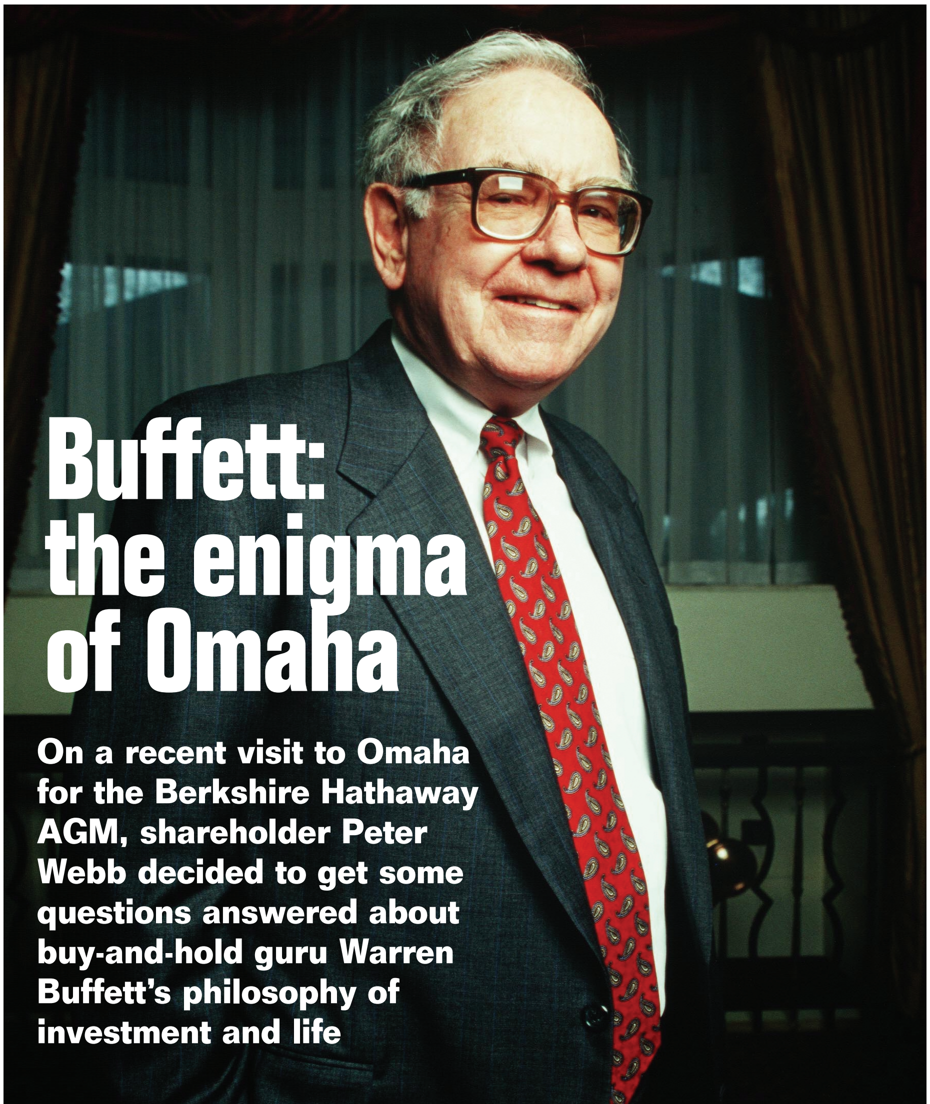
PHOTO OF WARREN BUFFETT: MATT GREENSLADE/NEWSCAST



Buffett: the enigma of Omaha

On a recent visit to Omaha for the Berkshire Hathaway AGM, shareholder Peter Webb decided to get some questions answered about buy-and-hold guru Warren Buffett's philosophy of investment and life

BUFFALOHEAD Dorothy
7309 Glenvale Dr OMA
Marie 5717 Pratt St OMA
Tami 3507 N 58 St OMA
BUFFAMONTE Buffy 8125 S 87 St LA VST
BUFFETT Warren E ofc
3555 Farnam St OMA
BUFFINGTON Arthur C 1308 N 56 St
Dorothy 105 E 4 St RPLN
Jack
Jason 212 Meadow Dr GRTN
Jason & Bridget 14813 Olive St OMA
Jason & Bridget T 212 Meadow Dr GRTN
Thomas J & Carol 13704 S 131 St
Tom & Raelynn 8461 Browne St OMA
BUFFINTON Merlin W 9820 Saratoga St
BUFFORD Tiffany 6516 N 31st Ave OMA

Has there ever been a less pompous billionaire than Warren Edward Buffett? It is tempting to wonder not only how such a man came to measure his net worth in billions but also whether he might not be a time-traveller from another dimension.

To most of the financial community across the world, Buffett continues to be an enigma. His name commands as much respect on Main Street as it does on Wall Street, thanks to his old-fashioned thoughts and methods, which stand in stark contrast to the modern world where decisions are needed yesterday and prices are checked every second. Buffett ignores conventional wisdom and continues to swim successfully against the tide.

On Farnam Street leading to Downtown Omaha is Buffett's house: it's a modest home for a multi-billionaire. He bought it for $31,500 in 1957 and has remained there ever since. It's the sort of house you would probably see in some Surrey suburb, though this house has a rather greyish-brown façade. He has remodelled it, though, and added rooms and a handball court. A local real estate agent tells me it is probably worth $500,000 now.

Confirming the Omaha address was not a problem – Buffett is in the phone book. Or perhaps I should have asked his business partner and friend, Berkshire Hathaway vice-president Charlie Munger. For it was the 80-year-old Munger who walked past me while I was waiting for a shuttle bus earlier in the day. He was on the way to his car, parked in the same parking lot as everybody else. I had not expected to encounter a multi-billionaire in such casual circumstances.

What a lot of people don't realise, though, is that Buffett also owns a house in California – a $150,000 summer home at Laguna Beach bought, it seems, at his wife's request in 1971. It is worth around $4 million now.

I guess in retrospect not putting too much money into property was probably a good idea for Buffett, given his investment record: he has significantly outpaced the equity market, which in turn has beaten the returns available on property.

Unlike his investments, which he holds for some time to avoid tax and to compound his gains, Buffett wants to be taxed on his house. He suggested tax rises to Arnold Schwarzenegger when the actor campaigned for election as Governor of California, citing the imbalance between the property taxes he pays on his homes – $14,401 in Nebraska and $2,264 in California. He was also against double taxation relief agreed by the Senate last year, indicating that it was the richer part of the population who would gain from this relief and not the population in general.

These views tie in with his view on inherited wealth. Buffett is opposed to liberal inheritance tax. 'Dropping inheritance tax would be like choosing the 2020 Olympics team by picking the eldest sons of the gold medal winners in the 2000 Olympics,' he says. He believes that if you remove the driver for creating wealth, then in the long term you will probably remove that wealth at a cost to broader prosperity. It seems Buffett's aim is not a dynasty. On another occasion, when asked what the right amount to leave one's children was, Buffett retorted, 'a few hundred thousand ought to do it'. He argues that if talent can't be passed down to later generations, neither should money, and he plans on leaving the lion's share of his fortune to the Buffett Foundation.

Berkshire Hathaway is about management with a small 'm'. Buffett reminds us on many occasions that head offices should be small, and his has only 16 people working in it. Not many for a company that turns over $64 billion. One reason for this is that he lets the chiefs of the companies Berkshire acquires run their businesses as before, except that he makes them transfer their excess cash to Omaha and they have to clear their capital-spending plans with him. He see his role as Berkshire's 'capital allocator', collecting the enormous cashflow that the subsidiaries produce and using the money to buy more businesses through the stock market.

It sounds like a simple enough process. 'We don't believe in asset allocation – it's nonsense,' he says. 'We buy what makes sense today. We have no idea what is happening tomorrow so we don't try and make decisions based on that.' Against the conventional wisdom of most fund managers and investment advisers, Buffett and Munger suggest NOT diversifying your investments, an approach that in the UK would attract the wrath of the FSA.

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'Diversification is wrong,' says Munger. 'If you are intelligent enough and have thought about it there is no reason to be timid. The best way to minimise risk is to think.

'Asset allocation is nonsense. We keep to short-term investments until we see an opportunity then we take it. In my view, asset allocation is just more merchandising by the sell side.'

Most of this would appear to be because they are confident with their investments and therefore do not need to diversify away from what they regard as good decisions.

Everybody knows Buffett will only come up with a price that offers him an attractive return. So why do people sell at that price when they know they are being low-balled? Especially in the context of increasing rivalry from private equity funds.

Buffett says: 'Sure, private equity funds are a form of competition to Berkshire. When you are in an auction, market prices can do strange things. When you buy a business you are buying at a negotiated price so the prices are always higher than purchasing stock. But we still prefer to buy a whole business rather than just common stock, even if the common stock is slightly cheaper.

'People sell to us because we are one of a kind: we will buy a business and still let the original owners run it like they always have. If they have a tax reason or a family situation and they need to sell it off, they may not want to auction it like a piece of meat to some guy who will leverage it up and sell if off in a few years.

'It's kind of silly to auction off your daughter to the highest bidder. If you have invested a lot of time and effort to get to this stage, why do it? My promises are about as good you will get in this arena.'

Buffett only takes a salary of $100k for running Berkshire Hathaway. With roughly one million 'A' shares outstanding, he effectively manages each $100k (rough current price of an 'A' share) for 10 cents. A minute fraction of the fees a normal fund manager or investment trust would charge. Why doesn't he accept a higher salary or adopt a fee structure?

'I've said before I love this job so much I would be willing to pay to do it,' he says. Besides, he holds a very large amount of equity in the company. The core Buffett view is that if the owners, like the CEO, have large amounts of equity in the business, then they should not take a large salary. If they are doing a good job, then their equity will grow enough on its own.

Predictability is everything for Buffett. 'If we don't have earnings and price predictability, we're not in the stock. You get predictability only from simple companies. Simple stocks are the only stocks that give you predictability.'

Being predictable compounds to quite a lot over time, and as Buffett holds for long periods it all adds up. The problem with technology companies, and therefore ones that are not simple to understand, is that they often use a lot of cash reinventing themselves on the next product or technology cycle. This is something that simple companies do not need to do. It may be true that elephants don't gallop but they tend to trample everything in their path.

Mulling these many thoughts, later in the day I went to downtown Omaha with some friends for a drink. We found an Irish bar and ordered drinks. The phrase of the day was 'What would Warren do?', so my friend asked the barmaid, 'What would Warren drink?' She replied, 'Err....Warren wouldn't drink here.' Perhaps we still have much more to learn about Buffett.

On consideration, it appears that businesses sell to Buffett in deference to the other alternatives they have available, and that the moral advocacy he espouses is a reflection of the way he would like to be viewed and trusted. This extends into pretty much all aspects of his life: it is part of Buffett.

Sellers of businesses like this, and his promise never to sell their 'babies'. Therefore they are willing to accept a price more favourable to Buffett on the basis that their interests will be well served.

There are two ways you can view this: either that he has to act this way in order to maintain this mode of operation or that maybe his mode of operation enables him to retain this competitive advantage in an increasingly competitive industry.

Whichever view you take, do not underestimate the skill of somebody who can turn an idea into a $120 billion company consistently over the course of many years. Speaking as a shareholder, long may that continue.

If you would like to become a Berkshire Hathaway shareholder then the A shares are available to purchase at around $90,000, or if that is beyond your budget then you can opt for B shares at around $3000. The B shares only carry 1/200 of the voting rights but both entitle you to attend the famous annual general meeting in Nebraska.

I look forward to seeing you there next May. ■

PETER WEBB

Peter has been an active private investor for 14 years and regularly tutors and presents for Global Markets Training. He has spent most of his career bringing technology products to the UK and European markets for a variety of major (and not so major) consumer brands.

Having worked at all levels of the supply chain he now balances his time between being at the cutting edge of businesses and growing the depth and breadth of his investments.