What makes Warren Buffett tick? Since 1977, the US investment guru's annual letter to shareholders has attracted increasing attention as he surveys the markets and comments in his folksy way. But there is a dearth of information from the days before he started communicating his thoughts – particularly from the days when he was just starting out in an investment partnership.

Peter Webb was recently lucky enough to be able to read and research all of Buffett's early partnership letters. It gave him a unique picture of life in the partnership and allowed him to fill some of the gaps regarding the life and times of Warren Buffett

Buffett: the lost letters

EXCLUSIVE:

In the spring of 1956, the 26-year-old Buffett returned from New York to his home town of Omaha, Nebraska. He rented a house on Underwood Avenue and banded together seven limited partners – his sister Doris and her husband, his Aunt Alice, Doc Thompson, his ex-roommate Chuck Peterson, his mother and his lawyer. In total he raised $105,000 in capital. Ever the prudent man, he dug deep and put in $100 himself. Buffett Associates was born.

The terms for investment in the partnership were simple. Money could only be invested once a year and any profits Buffett made for them up to 4% were theirs. Anything beyond that would be split, 75% of the profits to the partners and 25% for Buffett.

In his regular letters to partners, you witness his prose flip-flop around different aspects of his investment performance. Often a page is devoted to some particular topical subject. He regularly summarised his general strategies into three distinct classifications.

The first strategy consisted of buying undervalued shares. He generally had fairly large positions (5% to 10% of total assets) in each of five or six stocks, with smaller positions in another 10 or 15. Of course, there was no timetable on when these stocks would return to favour in the market and Buffett was always clear about that. He wrote: 'It is difficult at the time of purchase to know any specific reason why they should appreciate in price. However, because of this lack of glamor or anything pending which might create immediate favorable market action, they are available at very cheap prices.'

Buffett felt comfortable with paying a good price coupled with a bit of diversity. Some things don't change and Buffett noted that over the years his timing of purchases had been considerably better than his timing of sales: 'We do not go into these generals with the idea of getting the last nickel, but are usually quite content selling out at some intermediate level between our purchase price and what we regard as fair value to a private owner.'

His general expectation was for an outperformance of the main market but that was more likely to come when the market was flat or in decline. 'I would consider a year in which we declined 15% and the Average (Dow) 30% much superior to a year when both we and the Average advanced 20%.

'Over a period of time there are going to be good and bad years; there is nothing to be gained by getting enthused or depressed about the sequence in which they occur. The important thing is to be beating par. A four on a par three hole is not as good as a five on a par five hole and it is unrealistic to assume we are not going to have our share of both par threes and par fives.'

It is interesting that early in the partnership Buffett was still quite heavily into items that I would typically define as arbitrage – events such as mergers, liquidations, reorganisations and spin-offs. In 1956, he was split 70/30 between general investing situations and 'workouts' as he called them.

Early in the partnership Buffett seemed to have quite a few on the boil at any given time. He commented that he may have 10 to 15. It was interesting to note his use of leverage: 'I believe in using borrowed money to offset a portion of our workout portfolio since there is a high degree of safety in this category in terms of both eventual results and intermediate market behaviour.'

PHOTO: NEWSCAST

Results, excluding those benefits gained from the use of borrowed money, usually fell in the 10% to 20% range. 'My self-imposed limit regarding borrowing is 25% of partnership net worth. At times we owe no money and when we do borrow, it is only as an offset against workouts.'

Taking control

Buffett was also a pro-active investor. He had a general strategy that he defined as 'control' situations. These were where he would either take control of the company or take a very large position and attempt to influence the policies of the board. Buffet would identify companies where a change in management could lead to a satisfactory return on his investment and then start buying up their shares.

If he could acquire enough shares at the right price and get a seat on the board, he would do so and attempt to start influencing management to perform better. Where he could get outright control of the company, he would, then appoint an appropriate manager. Buffett doesn't appear to have had a taste for running the business himself. If the stock price started to rise and he was unable to gain control, he would simply sell out at a profit.

There are a couple of well-documented cases of successful investments contained in the partnership letters in which the detail is particularly revealing. Dempster is one of them.

This was a manufacturer of farm implements and water systems, with sales in 1961 of only about $9 million. Buffett built a position, eventually owning 70% of the shares. With only 150 or so other stockholders, liquidity was virtually non-existent.

As letters to the partners progress, a story unfolds of how Buffett appointed a manager who cut costs, streamlined the business and started to generate cash from it. Cash that would, of course, be funnelled to Buffett to look for the next investing idea.

Buffett was always smart. While the investments were compounding away at a breakneck speed, he never missed a trick. Buried in one of the letters is a note to partners about depositing funds. As he only allowed new funds to be deposited once a year, he offered partners the chance to place money early. He would pay 6% interest on this deposit until such time as he had the chance to put it to use. Effectively another form of cheap capital for Buffett.

In October 1967, Buffett was already warning about the lack of opportunities: 'Whatever the cause, the result has been the virtual disappearance of the bargain issue as determined quantitatively.' Eventually, on 29 May 1969, in his letter to partners he announced his resignation.

He describes how he had arrived at his decision: 'Opportunities for investment that are open to the analyst who stresses quantitative factors have virtually disappeared... Our $100 million of assets further eliminates a large portion of this seemingly barren investment world, since commitments of less than about $3 million cannot have a real impact on our overall performance... A swelling interest in investment performance has created an increasingly short-term-oriented and (in my opinion) more speculative market.'

Over the length of the Buffett partnership between 1957 and 1969, Buffett's investments grew at a compound annual rate of 29.5%, crushing the Dow's return of 7.4% over the same period.

The end had arrived and Buffett gradually wound up the partnership. But the new dawn had already started. Back in 1962, he started buying the shares of a textile business at a price of $7.62. The company was called Berkshire Hathaway and would eventually become Buffett's main vehicle for his future investments.

A change of direction

Another important event happened in 1962 that changed the direction of everything. Buffett consulted Charlie Munger on Dempster. Munger had moved back to his childhood home of Omaha from California.

Introduced by mutual friends, Buffett and Charlie were immediately drawn together, providing the roots for a friendship and business collaboration that would last for the next 40 years.

On 10 May 1965, after accumulating 49% of the common stock, Buffett named himself a director of Berkshire Hathaway. Terrible management had run the company nearly into the ground but he was certain that, with a bit of tweaking, it could be run better.

However, Berkshire was a difficult business and, as the US textile industry withered in the face of foreign competition, Buffett began redeploying the company's capital into an array of other businesses, including insurance.

In 1970, Buffett named himself chairman for the first time and wrote his first annual letter to the shareholders. That year, textile profits were only $45,000, while insurance brought in $2.1 million and banking $2.6 million.

The paltry cash from the struggling textile business had provided the stream of capital necessary to start building Berkshire Hathaway into a different type of business and the rest, as they say, is history. Berkshire Hathaway 'A' shares currently sell for around $85,000 each. ■

BUFFETT PARTNERSHIP PERFORMANCE

Year	DOW	Partnership
1957	-8.4%	9.3%
1958	38.0%	32.2%
1959	20.0%	20.9%
1960	-6.2%	18.6%
1961	22.4%	35.9%
1962	-7.6%	11.9%
1963	20.6%	30.5%
1964	18.7%	22.3%
1965	14.2%	36.9%
1966	-15.6%	16.8%
1967	19.0%	28.4%
1968	7.7%	45.6%

Returns stated after general partner fees of 25% after an annual distribution of 6% to the partners.

Buffett partnership timeline

1956:	Buffett, aged 27, starts Buffett Associates with initial capital of $105,100.
1957:	With Susan about to have her third child, Warren purchases a five-bedroom house. It costs $31,500. Buffett still lives there.
1958:	The third year of the partnership completed, Buffett has doubled the partner's money.
1959:	Warren's first introduction to Charlie Munger, who will eventually become the vice-chairman of Berkshire Hathaway.
1960:	Warren raises more funds.
1961:	Buffett makes his first $1 million dollar investment. It is a company called Dempster.
1962:	The Buffett Partnership, which began with $105,000, is now worth $7.2 million. Buffett starts buying Berkshire Hathaway stock.
1963:	Buffett sells Dempster for three times the amount he invested.
1964:	American Express shares fall to $35. While the world is selling the stock, Buffett begins to buy shares en masse.
1965:	Buffett begins to purchase shares in Walt Disney Co. after meeting with Walt personally.
1966:	Warren's personal investment in the partnership reaches $6,849,936.
1967:	American Express hits over $180 per share, making the partnership $20 million in profit on a $13 million investment.
1968:	The Buffett Partnership earns more than $40 million, bringing the total value to $104 million.
1969:	Following his most successful year, Buffett closes the partnership and liquidates its assets to his partners.
1970:	Buffett becomes chairman of Berkshire Hathaway.