

Chapter 10

Bazooka Hank and Dread Reckoning (AIG, Fannie, Freddie, Lehman, Merrill, and Other Fluid Situations)

If they sell five percent of it, they'll get the market price.

—Warren Buffett
to Janet Tavakoli, August 10, 2007

Before the fall of 2007, few besides Warren Buffett, John Paulson (Paulson & Co.), Bill Ackman (Pershing Square), David Einhorn (Greenlight Capital), Jim Rogers (Rogers Holdings), and I specifically challenged investment banks' prices of complex structured products. On August 9, 2007, I told CNBC that "when you get truthiness in lending

you get truthiness in pricing.” Even with corporate leveraged loans, there is “too much foam and too little beer.”¹ Many AAA rated money market investments were losing money because they were backed by CDOs backed by subprime loans. Becky Quick of CNBC asked who is vulnerable, and I responded just about every investor: hedge funds, REITs, insurance company investment portfolios, mutual funds, and money market funds might lose money.



The next day, I challenged American International Group Inc.’s (AIG) accounting, after it told analysts it did not need to show a loss (reflecting a change in market prices) on its credit derivatives portfolio for its second quarter ending June 30, 2007. Yet, accounting practices required AIG to mark to market its portfolio using market prices or a close approximation to market prices. The rule did not say *only if you feel like it*. AIG seemed to take the position that (1) nothing like this is currently trading, so there is no market price; and (2) AIG would never have to make any cash payments because its portfolio was so “safe.” Accounting gives one a lot of room to make reasonable assumptions, but how could AIG say nothing had changed?

For example, AIG wrote credit default protection on a whopping \$19.2 billion “safe” investment that had exposure to subprime loans (a super-senior tranche of a CDO backed by BBB rated tranches—the lowest rating that is still investment grade—of residential mortgage-backed securities, and these were backed by a significant amount of subprime loans. By August 2007, the prices of the collateral backing the super senior had tanked.)² Anyone who buys insurance knows that even if you are “safe,” if you are in a high-risk category, your cost of insurance goes up. If AIG were to pay someone to take over its insurance-like obligation, AIG would have to pay more than it had received, and AIG should have shown this as a loss.

AIG’s stance seemed bizarre given that five insurance executives from AIG and Berkshire Hathaway’s Gen Re Corp (even Warren Buffett cannot control every action of every employee) were under

investigation (and eventually found guilty) of conspiracy to inflate AIG's reserves and mislead investors about AIG's earnings.³

I told Dave Reilly at the *Wall Street Journal*: "There's no way these aren't showing a loss."⁴ That is simply a market reality. *This is Wall Street speak for*: In my humble opinion, you are a big fat liar. AIG responded: "We disagree."⁵ *That is Wall Street speak for*: No, YOU are a big fat liar!

Before Dave Reilly wrote his article, he talked to experts, including me, for background. Then he called AIG to ask them for their thinking. AIG stood firm. Then Reilly called me again. He didn't want the *Wall Street Journal* to look stupid, but told me, "they pay me to go out on a limb." He said he needed me to go on the record. It would make the article more forceful. I did not think that AIG would tell Reilly: *You know, you have a point, maybe we should recheck our homework*, but I did not anticipate arguing with AIG in the *Wall Street Journal's* "Heard on the Street" column. I hesitated. AIG, a large global conglomerate, has the resources to crush me like a bug. On the other hand, *I am not fat*. I finally agreed to go on the record.

By June 2008, AIG recorded two back-to-back quarters of its largest losses ever. AIG took more than \$20 billion in write-downs on its derivative positions through the first quarter of 2008; net losses for the fourth quarter of 2007 were \$5.3 billion, and in the first quarter of 2008, AIG reported losses of \$7.8 billion. In February 2008, its auditor said it found "material weakness"⁶ in AIG's accounting. Eli Broad, a billionaire real estate baron, Shelby Davis of Davis Selected Advisers LP, and Bill Miller of Legg Mason Inc., were AIG shareholders controlling 4 percent of the company (more than 100 million shares). These already accomplished men may have a hidden talent. Apparently, they can read my mind. These shareholders wanted changes in senior management and a *new* CEO, and they wrote AIG's board: "The facts presented . . . preclude any individual who was in a position of significant responsibility and oversight during the last three years from having the credibility to lead this company on a permanent basis."⁷ *That is shareholder speak for*: We are not calling those responsible for oversight big fat liars, we are just saying they have no credibility.

By the summer of 2008, more than nine months after the August 2007 *Wall Street Journal* story, the Slumbering Esquire's Club (also known as the SEC) and the Department of Justice were investigating whether AIG

had overstated the value of its credit derivatives exposure to subprime mortgages.⁸ In the summer of 2007, the SEC might have questioned *everyone's* accounting. Well, not everyone's—just several large investment banks and various other entities that the SEC regulates.

Likewise, OFHEO, then regulator of Freddie Mac could have questioned Freddie's accounting. In 2004, David A. Andrukonis, then chief risk officer for Freddie Mac, was concerned about Freddie's purchases of bad mortgage loans. He told then CEO Richard Syron that the loans would probably “pose an enormous financial and reputational risk to the company and the country.”⁹ While taking on more risk was bad enough, the Department of Treasury reviewed Freddie's books in preparation for a bailout and concluded in September 2008 that its capital cushion had been overstated by Freddie Mac's accounting methods.¹⁰

On July 15, 2008, ex-Goldman Sachs banker and then Treasury Secretary Henry (“Hank”) Paulson asked Congress for the authority to buy stakes in Fannie Mae and Freddie Mac. Paulson asserted: “If you have a bazooka in your pocket, and people know you have a bazooka, you may never have to take it out.”¹¹ In my experience, boasting about a big bazooka just tempts the curious to see how you measure up in exciting circumstances, and the person to do that might be named Mr. Gross. Bill Gross manages the Pimco Total Return Fund, the world's largest bond fund with large exposures to Fannie Mae and Freddie Mac (and AIG along with a number of investment banks as of September 2008). Gross is a fan of Fed intervention, and his investments reflected it. His fund reportedly gained \$1.7 billion after the U.S. government took over Fannie Mae and Freddie Mac on Sept 7, 2008.¹² Fannie Mae and Freddie Mac were placed in conservatorship to be run by their new regulator, the Federal Housing Finance Agency (FHFA) headed by James Lockhart, the same gentleman that headed up their former regulator, OFHEO. What was the thinking on choosing Mr. Lockhart—*let's give him another chance, because he cannot possibly do a worse job than he did before?* The Treasury may purchase up to \$200 billion of stock, dividends were suspended (long overdue in my opinion), and the CEOs were replaced. Both Fannie Mae and Freddie Mac were removed from the S&P 500 on September 9.¹³ Herb Allison, a former CEO of TIAA-CREF, will head Fannie Mae. David Moffett, retired vice chairman and chief financial officer of U.S. Bancorp,

became the CEO of Freddie Mac. Mr. Moffett was most recently a senior advisor to the Carlyle Group.^{14,15} *Business as usual in Washington.*

In September 2008, AIG's problems grew worse. One of the reasons AIG may have initially resisted showing losses on its credit derivatives positions is that price declines triggered a need for more cash to meet collateral calls from AIG's trading counterparties. Warren was right. Credit derivatives are weapons of mass *liquidity* destruction. By the end of July 31, 2008, the company that refuted my August 2007 assertion that it had risk from credit derivatives, had already put up \$16.5 billion in collateral. To paraphrase Warren, *AIG sucked its thumb in 2007.* AIG was in the midst strategic review and had set its deadline at September 25, 2008.¹⁶ The Fed took over AIG on September 15.

Moody's rated AIG Aa2 at the beginning of May 2008, and downgraded it to Aa3, the lowest double-A rating, on May 22, 2008. In early September 2008, AIG's rating neared single-A territory. AIG had lived in denial for more than a year. It had failed to sell assets to raise the cash it needed to face additional margin calls (triggered by the downgrade) of \$14.5 billion. AIG has valuable assets, but the assets are illiquid and AIG was short of cash. On September 15, 2008, AIG was downgraded to single-A. AIG asked the Fed for a loan. When the Fed resisted, it sought a \$75 billion loan from Goldman Sachs and JPMorgan Chase.¹⁷ No dice.

Goldman Sachs said its exposure to AIG is not material.¹⁸ Of course, it wouldn't be if Goldman's trades have collateral triggers (or if it bought credit default swap protection on AIG). A better question is, what is the combined trading, insurance and reinsurance exposure of Bazooka Hank's old firm if AIG did not have to pony up so much of its cash and if Goldman had no default protection on AIG? *Is it material?* JPMorgan is one of the largest credit derivatives traders in the world, and with its acquisition of Bear Stearns, it was probably the largest. AIG sold credit default protection on \$441 billion of assets to a number of European and U.S. counterparties. If AIG could not make good on its promises, it would affect the entire financial community.¹⁹ The technical term for this is *systemic risk*. In this case it is the result of *global financial institutions doing foolish things at the same time.*

The Fed changed its mind and decided to give AIG the loan after all. Although the Fed never regulated AIG, it agreed to provide AIG with a \$85 billion credit line for two years (similar to a credit card with

an \$85 billion limit – *wouldn't you just love one of those?*) in exchange for interest payments and stock warrants (the right to buy, under certain conditions, up to 79.9 percent of AIG). The Fed will end up controlling a private insurer *with the help of U.S. taxpayer dollars*.²⁰ What gave the Fed the right to do that? It invoked an obscure rule under section 13(3) of the Federal Reserve Act with the full support of Bazooka Hank's Treasury Department, just as it did when it helped JPMorgan Chase purchase Bear Stearns.²¹ The new Wall Street speak for institutions like AIG that have illiquidity problems requiring intervention is that the "situation is fluid." It remains to be seen how successful the Fed will be in stabilizing and making a profit (or loss) from AIG.

Bill Gross's Pimco Total Return Fund had sold \$760 million of default guarantees (as credit default swaps) on AIG, and it would have cost him if AIG went under.²² Mr. Gross might have thought he had a good idea of how the Fed would behave. Pimco had hired Alan Greenspan as a consultant.²³ I was not surprised when Bill Gross said the Fed intervention was a "necessary step."²⁴

AIG seemed to have lost the plot on its cash needs, especially those linked to CDOs. In April of 2008, Warren told a group of University of Pennsylvania students that when it comes to CDOs, "Nobody knows what the hell they're doing. It's ridiculous."²⁵

Accountants do not seem to know what they are doing, either.



Accountants allow corporations to put assets into three "levels." The "level" indicates how easy it is for someone to check your work, with Level 1 being the easiest. Level 2 requires you to accept assumptions that you can supposedly recreate with enough hard work and data. *Do you have several hundred thousand dollars and an army of geeks?* Level 3 requires you to trust management assumptions that you cannot see and they do not disclose—it is reminiscent of teenage boys at their first prom: *trust me, I will love you in the morning.*

Level 1 is mark-to-market-based on observable market prices. For example, if you own stocks, you can find the prices very easily online.

It is easy to calculate the value of your stocks every day. This is what accountants mean by mark-to-market. Since it is easy to do and anyone can check your work, it is *transparent*.

Level 2 is mark to model. Prices are based on models using observable assumptions. Accounting gives you some room to make assumptions. You cannot easily find prices in the market on many CDOs. You can debate mark-to-model prices. For instance, the creditors of BSAM challenged the April 2007 prices of the two hedge funds. Since management can control the assumptions, even with “observable” inputs, Level 2 can be “mark to myth.”

Level 3 accounting allows management to come up with prices based on models using *unobservable* inputs. In the absence of any other disclosure, I consider Level 3 purely mark to myth. It is a black box. *You have no evidence that management is leveling with you.*

Benjamin Graham put it another way. The formulas may be precise, but the assumptions may be self-serving and can be used “to justify practically any value .. however high.”²⁶

FASB board member Donald Young says that mark-to-market accounting is “most valuable”²⁷ when markets are tough. If prices decline, it signals investors that assets are under stress. If managers make up their own estimates instead of marking-to-market, it can be “mark-to-management”²⁸ or as Warren Buffett says again, it can be “mark to myth.”²⁹ If companies think prices will recover in future, they can explain it in their regular reports (the regulatory filings with the SEC).

In August 2007, Warren told me that if financial institutions sell 5 percent of their position, they will get the market price, and it will still be a higher price than they would get if they tried to sell 100 percent of a large illiquid position. He laughed as he added: “No one wants to do that.” In September 2007, *Fortune* reported that some financial institutions might appear healthy, but leveraged institutions might actually be insolvent if they marked-to-market instead of marked to model. “Many institutions,” Warren said, “that publicly report precise market values for their holdings or [sic] CDOs are in truth reporting fiction,” adding “I’d give a lot to mark my weight to ‘model’ rather than to ‘market.’”³⁰ Warren explained that selling 5 percent of their positions would reflect reality. I wrote Warren that I call this *Warren Buffett’s Five Percent Solution*. He wrote back: “In the print edition of *Fortune* they changed

“of” to “or” in the first sentence, though I got it corrected online.” I responded: “I am usually fast and accurate, but rarely impeccable and precise.” *He sets a high bar.*

The SEC seemed to have another idea. The last weekend in March 2008 (a couple of weeks after the Fed said it would exchange AAA assets for Treasuries), the SEC’s Division of Corporate Finance issued a letter that could have been called *Retroactive Amnesty for Potential Alleged Accounting Fraud*. The letter concerned public companies and disclosure issues they “may wish to consider”³¹ when preparing their regulatory filings. It said that under current (tough) market conditions, public companies might be required to use models with “significant unobservable inputs”³² So, as of January 1, 2008, the companies could put those assets in a black box (Level 3).

The SEC appeared to override the accounting board. Since when does the SEC interpret accounting rules that contradict public pronouncements by FASB? Yet the SEC seemed to encourage investment banks to classify more assets as “Level 3.” Classify they did. For example, in early May 2008, Goldman Sachs Group Inc. announced that for its fiscal quarter ending in February, it increased its Level 3 assets by 39 percent or by more than \$27 billion. It had \$96.4 billion in assets sitting in its Level 3 accounting bucket. Morgan Stanley had \$78.2 billion in assets sitting in its Level 3 accounting bucket. Merrill Lynch announced that its mark-to-myth assets increased from \$48.6 billion at the end of 2007 to \$82.4 billion for the first quarter ending March 31, 2008 (Merrill is on a different fiscal calendar), an increase of 70 percent.³³ The list goes on. Merrill Lynch’s new CEO, John Thain, brought in 51-year-old Tom Montag from his old Goldman Sachs stomping grounds to head up global trading for around \$40 million.³⁴ Wouldn’t you think that for that kind of money, Merrill could disclose their assumptions?

How could one value Merrill Lynch, Lehman, or any of the other investment banks? How could anyone trust their numbers?

Lehman announced a probable loss for second quarter 2008 of \$2.8 billion, the first loss since going public in 1994. It came as no surprise when Lehman said it might boost its Level 3 assets. It raised \$12 billion in new capital between February and the end of May, and said it would raise \$6 billion in new equity diluting shareholder equity by 30 percent. Through sales, it reduced leverage from 31.7 times to 25 times. It sold

\$130 billion in assets (*but it did not specify how it sold all of those assets so quickly or to whom*).³⁵

Richard “Dick” Fuld, the 62-year-old then CEO, was a Lehman lifer. In December 1983, when Fuld was chief of trading operations, he made a presentation to Lehman’s board as it met over lunch to assess capital needs. Richard Bingham asked Fuld how he had made money in his trading operations the previous five years and how he would make it the next five. Fuld responded: “I don’t know how I made it over the last five years.”³⁶ Fuld added he had hired people “to study how we’re going to do it over the next several years.”³⁷ An appalled Bingham asked how long that would take. Fuld responded: “Two years.”³⁸ *I wonder if Fuld completed the study.*

The SEC quickly moved to give the appearance it was on top of things. After all, we wouldn’t want another debacle like Bear Stearns, would we? The SEC said it would require Wall Street to report its liquidity levels and its capital starting later in 2008. The SEC wants disclosures “in terms that the market can readily understand . . .”³⁹ *Oh, really? About that letter the SEC sent in March. . . . That ship has sailed.* After financial institutions stuff tens of billions of dollars worth of assets into a black box (Level 3 accounting buckets), how is the market supposed to readily understand? The Federal Reserve Bank, the new liquidity provider for Wall Street, seemed to have no idea of what was going on, either. The American taxpayer should ask for a refund for the money allocated to keep the SEC in operation. It makes one wonder just what it would take to get Christopher Cox booted out and have a thorough housecleaning at the SEC.

I do not as a rule weigh in on quarterly earnings statements, but I will occasionally volunteer my views just to keep making the point. I had publicly challenged AIG’s writedowns in August 2007, Merrill’s in early October 2007, and challenged Citigroup’s reported numbers in January 2008. I told the *Wall Street Journal* that Citigroup might need \$3.3 billion more in write-downs on its “super safe super senior” positions to reflect market prices. That would have increased Citigroup’s overall write-down due to subprime from \$18 billion to \$24 billion. Citigroup raised new capital that diluted shareholder equity by 10 percent. In the new world of financial topseyturveydom, *diluting shareholder equity was touted as a good thing*.^{40,41} Warren aims to *preserve* shareholder value.

Oppenheimer's bank analyst Meredith Whitney wrote a report on October 31, 2007, saying that Citigroup's dividend exceeded its profits, saying, "it was the easiest call I ever made."⁴² Since that Halloween day in 2007, Wall Street has been paying closer attention to Meredith Whitney's reports. It seemed to take more than a month before other Wall Street analysts woke up to the problem. Bear Stearns' bank analyst David Hilder thought her concerns were overstated. He was wrong, of course. *Where did Bear Stearns find these guys?*

Citigroup's losses continued to mount. As of October 2008, Citigroup's subprime-related write-downs are \$60.8 billion.⁴³ Vikram Pandit had been CEO of Citigroup just over a month when the numbers I challenged were reported. Pandit cofounded Old Lane Partners in 2006 and sold it to Citigroup in July 2007 for \$800 million. His personal take for his share was \$165 million, but he plowed \$100.3 million of it back into the fund. By June of 2008, Citigroup shut it down. The *Wall Street Journal* reported the fund "has been dogged by mediocre returns and the loss of its top managers." Old Lane had raised \$4 billion from investors and borrowed \$5 billion more. Citigroup agreed to take \$9 billion of assets onto its balance sheet after writing down \$202 million. Whatever you may think of Pandit's qualifications to lead Citigroup, it seems he knows how to time a sale.⁴⁴

Lehman was not so lucky with its sales; it could not raise cash when it need it. Many questioned Lehman's accounting. David Einhorn of Greenlight Capital had publicly questioned Lehman's first quarter accounting numbers. Lehman reported a \$489 million "profit" and only took a \$200 million gross write-down on \$6.5 billion on its holdings of asset backed securities. Einhorn complained that (among other things) Lehman did not disclose its significant CDO exposure until more than 3 weeks later when Lehman filed its 10Q (a required financial report).⁴⁵ In October 2008, Lehman and Tishman Speyer engineered a \$22.2 billion leveraged buyout of Archstone, an apartment developer. *Fortune* said Dick Fuld declined to talk to it for months and it seemed to *Fortune* that the Archstone deal had losses almost from the start.⁴⁶

Richard Fuld tried to sell a stake in his separate asset management unit to stay afloat. He was unsuccessful. Lehman Brothers worked during the weekend of September 13 and 14 with a group of potential

buyers. Bankers wanted the Fed to participate, but the Fed refused. Bankers fretted about how they would unwind (sell out) their derivatives trades with Lehman. On Monday, September 15, 2008, Lehman Brothers Holdings Inc., a 158 year-old firm, filed for bankruptcy. It is still alive in the minds of its creditors, since they will not know what they have left until Lehman's assets are finally liquidated.^{47, 48} Hedge funds that used Lehman Brothers as their prime broker found "their" assets temporarily frozen. Like many other prime brokers, Lehman had provided financing for hedge funds to purchase assets, and now it was not clear whether Lehman or a hedge fund owned a particular asset. Like creditors, Lehman's hedge fund customers will have to wait until the mess is sorted out. Warren had been correct in warning that the leverage unwind would be painful, and it seemed hedge funds and investment banks failed to imagine all the ways it could cause pain.

John Thain as CEO of Merrill Lynch recognized that a Lehman bankruptcy could have negative implications for Merrill. He and Ken Lewis, Bank of America's CEO, hammered out an agreement, and on September 14, a Sunday night, Bank of America Corp. agreed to purchase Merrill Lynch & Co. in an all-stock deal for \$29 per share (at the time of the announcement worth about \$50 billion), a premium to its closing price the previous Friday. The combined firm will be a behemoth if the deal closes as planned in early 2009. Bank of America will get a broader global reach; Merrill's huge wealth management business; a huge trading operation; a prime brokerage business; and around half of Blackrock, an investment manager with \$1.4 trillion under management.⁴⁹ The Fed said it did not participate in a bailout, but it expanded its lending facility just after Lehman declared bankruptcy. It would take a wider variety of securities including *equities*.

In August 2008, Warren told me he read every page of Lehman's financial report. In March of 2008, Warren told me he had been approached about helping Bear Stearns, but he could not come up with a value in a weekend (and did not have \$60 billion in capital). He expanded on that to the students from the University of Pennsylvania when he said that bailing out Bear Stearns "took some guts that I didn't want to match."⁵⁰ The balance sheets of the investment banks are so difficult to figure out that one cannot tell whether one is getting a good deal.

Pimco's Bill Gross found there is a limit to the Fed's largesse, and his Lehman investment lost money. In March, Bear Stearns, the *fifth* largest investment bank, was deemed too big to fail, but the Fed refused to help Lehman, the *fourth* largest investment bank. As Jim Rogers predicted, larger investment banks than Bear Stearns had problems, and the Fed had other problems besides investment banks—Fannie, Freddie, and AIG. Pimco's investments were only partially protected by the Fed. The Total Return Fund's return slumped, and it will be interesting to see if Gross ends up a net winner or a net loser as the market struggles for balance.

Jamie Dimon, JPMorgan Chase's CEO, bought Bear Stearns, and Ken Lewis, Bank of America's CEO, bought Merrill Lynch. Did either of them get a good deal? Did both of them get good deals? Who got the better deal? Ken Lewis certainly passed up Jamie Dimon in size, but only time will tell how this plays out. For my part, it seems that Ken Lewis is the more underestimated of the two.

In May 2003, I heard both CEOs give luncheon speeches at the Federal Reserve's Conference on Bank Structure and Supervision. Jamie spoke the day before Ken Lewis. Jamie dressed in a light suit and spoke rapidly, sounding as if he had just drunk a pot of coffee. He seemed to suggest he had solved all of the problems at Bank One in the vein of a public relations speech (this predated its merger with JPMorgan Chase). He seemed uncomfortable with silence. In between questions the microphone was passed around for a few seconds. Jamie added to his already complete answers, and it seemed an attempt to fill dead air. The next day Ken Lewis spoke. He wore a conservative dark blue suit with a flag pin in his lapel. His grooming was impeccable. His speech flowed. Unlike Jamie, he spoke about corporate governance, the topic at hand. He gave clear and balanced reasons why (contrary to popular wisdom) it made sense in Bank of America's case for him to occupy the position of both chairman and CEO. Ken Lewis left me with the impression that he is a very ambitious man who comes prepared. He did not underestimate his audience.

Perhaps these CEOs have a better crystal ball than Warren Buffett and I. The list of accounting distortions seems endless,^{51, 52, 53} but the key is to understand business fundamentals first, and then consider what the accounting statements imply.

By October 2008, J.P. Morgan acquired Bear Stearns and Washington Mutual; BofA acquired Merrill; and Wells Fargo acquired Wachovia. Morgan Stanley and Goldman Sachs became bank holding companies. The Treasury invested tens of billions of dollars in each. AIG got a bail-out. Lehman was bankrupt. The situation is fluid. Meanwhile, Berkshire Hathaway has limited debt (leverage) and a lot of cash.



Starting around 1980, Berkshire Hathaway's *nonreported (undistributed) earnings* from the ownership of equities exceeded *reporting earnings* generated by the business it owns. That means there is a lot of hidden value that does not show up on accounting statements. Earnings and return on equity are important measures, but the *intrinsic value* of the company is the key.

Today, investors can purchase low-fee index funds, so a reasonable benchmark is the S&P 500. Each year, Berkshire Hathaway compares its performance with the S&P 500. Warren Buffett and Charlie Munger strive to increase intrinsic value, the true value including value that is obscured by accounting statements. They say that if they cannot beat the S&P that way, then they are not doing anything an investor cannot do on his or her own.

So far long-term Berkshire Hathaway investors, including me, have been delighted. No one can predict future performance, but long-term investors continue to hold their stock. Not only does Berkshire Hathaway invest in stocks and pieces of companies, many of the companies owned by Berkshire Hathaway also invest. If Berkshire Hathaway owns less than 20 percent (accounting rules are subject to change, so this percentage is just an example) of a company, it does not have to include (consolidate) the company's earnings on Berkshire Hathaway's balance sheet, even when this represents a huge wealth increase.

In 1990, Berkshire Hathaway owned 17 percent of Capital Cities/ABC, Inc. (Capital Cities). Berkshire Hathaway's share of Capital Cities earnings was \$83 million, but Capital Cities retained more than \$82 million (of Berkshire Hathaway's earnings) for future growth. Berkshire Hathaway only got about \$530,000 net after-tax dividends. According to *generally*

accepted accounting principle (GAAP), Berkshire Hathaway only had to record the dividends as earnings, so it recorded \$530,000 (not \$83 million). If Capital Cities/ABC, Inc. sounds unfamiliar to you that may be because Disney bought it in 1995⁵⁴ Berkshire Hathaway sold its holdings in Disney a few years after the takeover. *Warren's favorite holding period may be forever, but that does not mean he will hold something he no longer favors forever.*

Berkshire Hathaway prefers to purchase companies that generate earnings that do not have to be reported. If Berkshire Hathaway buys an entire business, Berkshire Hathaway must report the earnings. Sometimes, however, Berkshire Hathaway can acquire a minority interest in a company more cheaply (on a pro rata basis) than it would have paid for the entire company. Furthermore, Berkshire Hathaway does not have to report the earnings for the minority interest. The price is a relative bargain, and the unreported earnings should eventually become capital gains. In turn, the capital gains will increase Berkshire Hathaway's intrinsic value.

When Berkshire Hathaway acquires a company or part of a company, it looks for good managers. If the stock price falls below the value of the business the managers should buy back the stock. If the price is above the business value, however, managers will either (1) retain earnings if they can increase market value by a dollar for every dollar of earnings they retain; or (2) if they cannot do that, they should pay dividends. Good managers know these finance basics and follow them.

Accounting also misleads when it comes to the stock price that is recorded on the books (the carrying price). Berkshire Hathaway's subsidiaries may carry value at one price, while Berkshire Hathaway itself carries the same stock on its book at another price. Again, that is legal and proper accounting.

Highly leveraged investment banks stuff tens of billions of dollars worth of assets into black boxes (Level 3 accounting) and use other method to avoid showing market prices for assets (hold-to-maturity portfolios). The investment banks may have hidden problems. *Investment banks may be worth less than their accounting reports suggest.* In contrast, Berkshire Hathaway has *hidden value*. Berkshire Hathaway does not report retained earnings or capital gains on long-term investments unless the investments are sold.

Berkshire Hathaway reports fluctuations in market prices of its derivatives, however. Berkshire Hathaway took a loss on derivatives in 2007 and in first quarter 2008. Berkshire Hathaway's invested \$4.88 billion in premiums (up from \$4.5 billion at the end of 2007) for puts it wrote on equity indexes, and the first payment—in the unlikely event one ever comes due—is 2019. Berkshire Hathaway took a mark-to-market loss it can afford, a write-down of \$1.7 billion in the first quarter of 2008. Magen Marcus, a medical doctor who has been a Berkshire Hathaway shareholder for five years, called them “unrealized losses.”⁵⁵ *He is an informed shareholder.* In his 2007 shareholder letter, Warren told us that he and Charlie Munger are not concerned about the price fluctuations: “even though they could easily amount to \$1 billion or more in a quarter—and we hope you won't be either.”⁵⁶ They are willing to cope with reported earnings volatility “in the short run for greater gains in net worth in the long run.”⁵⁷

Berkshire Hathaway does not chase revenues for the sake of revenues; the price must be right. When rating agencies suggested that Berkshire Hathaway should increase insurance revenues to maintain its AAA rating, Warren told me he rejected their premise. Berkshire Hathaway is happy to do nothing when the risk is not priced correctly, but many insurance companies did not feel the same way. This critical difference led to an opportunity for Warren Buffett he never sought. An insurance regulator knocked on Berkshire Hathaway's door when it needed help.

