the reading room

the essays of warren buffet lessons for investors & managers

By Lawrence A. Cunningham
John Wiley & Sons
264 pages

review rating

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This is as near as you will get to a book “by” Warren Buffet, and for this reason more than any other, it is the best of the Buffet book bunch. Buffett has not actually written or published any book on investment, and all the other books are based upon insights gathered from his corporate essays/letters reported in the Berkshire Hathaway (BH) annual report (see below) or from discussing investment with him and learning from his ways. What makes this book so good, is that there is very little comment or interpretation – this is pure Buffett which has been “selected and arranged” from his many essays. Therefore, it is hardly surprising that, even with his genuine modesty, Buffet says that “If I were to pick one (Buffett) book to read, this would be the one”.

Cunningham is Director of the Centre of Corporate Governance and Professor of Law at the Cardoza Law School, New York City; another example of how much closer law and finance co-exist as disciplines in the US. The origin of the book (I read the revised 2002 edn) is a symposium held at Cardoza featuring this compendium of Buffett’s letters – which was attended by Buffett and his “partner” and BH Vice Chairman, Charlie Munger – another lawyer!

If you have read no other work on Buffett, you can safely start with this work and get right into it, beginning with the foundations of investment through the principles laid out by Ben Graham and David Dodd, who themselves taught Buffett. Don’t be concerned that some essays are a little old hat, in that some text goes back to the late seventies (all yearly references in the footnotes). Reason: Buffet pulls apart and denounces many of the modern theories of finance/investment and illustrates why the basic principles espoused by Graham and Dodd are superior to modern financial theory. Examples: compensation through stock options (Buffett is winning the public debate on this); the dubious benefits of synergistic acquisitions; the exaggerated benefits to be derived from cashflow analysis; and the gaping holes in modern accounting – although on the latter, Buffett acknowledges that there are often no simple solutions to complex issues.

Cunningham has divided the book into the primary subject areas covered by the essays, eg: corporate governance; corporate finance and investing; alternatives to common stock; M & A; accounting and valuation; accounting policy and tax matters. The reader should not be daunted by these seemingly weighty and technically laden areas, for the reason that Buffett’s writings have always been for the ordinary investor to understand. Thus, the approach is simple and replete with common sense arguments built over a lifetime of successful investing. The headings do however suggest the truth in the title, ie the book is for managers as well as for investors. A new CEO could do worse that make this his/her first read after appointment – particularly if, as Buffett says is generally the case, they are good at their commercial discipline/endeavour, but do not really understand the allocation of capital, which is of paramount importance to shareholders.

Chock-a-block with pithy wisdom

Buffett has a great way with words, borne no doubt from a lifetime of study and commercial engagement/intercourse at the highest levels. Cunningham picks all this out for us in his excellent introduction with such insights as: “having first rate people on the team is more important than designing hierarchies and clarifying who reports to whom about what and at what times” (remember: Buffett runs a vary large corporate empire of controlled companies); “stay away from businesses without favourable and durable economic and competitive characteristics” (Buffett has learned this the hard way); “ a stock that has dropped very sharply compared to the market … becomes ‘riskier’ at the lower price than it was at the higher price” (another nail in the coffin of modern finance when explaining the shortfalls of beta); and in reference to the hallowed principle of diversification (see below) we are reminded that “Keynes, who was not only a brilliant economist but also an astute investor, believed that an investor should put fairly large sums into two or three business he knows something about and whose management is trustworthy. On that view, risk rises when investments and investment thinking are spread too thin”, which observation is linked to the “circle of competence” concept, which holds that investors should be aware of the scope of their competence and stay within it – the primary reason why BH did not lose money in the tech wave, for as Buffett acknowledged, he did not understand it, and with a fermenting industry like technology his attitude is much the same as with space exploration “we applaud the endeavour but prefer to skip the ride”; and finally “as happens in Wall Street all too often, what the wise do in the beginning, fools do in the end”.

In revisiting these observations from the world’s greatest investor, I am reminded of the constant use of Buffett quotes by fund managers and financial planning groups as justification for their approach and products. The reality is that Buffett believes, as is pointed out in one of his letters, that most investors would do well to avoid actively managed funds (admittedly in the US context), and to simply put their money into the index – unless they can just focus on what they know, avoid undue diversification into unknown areas, and apply all the principles it has taken him a lifetime to learn from the worlds masters (eg, Graham and Dodd)!

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Again, Buffett is often used as justification for never trying to time the market – just hang in there and hope for the best, as no-one can call it. But even here, his writings have, it seems to me, been quoted out of context. His actual approach to market timing is far more sophisticated and pro-active. Indeed, as is pointed out in Hagstrom's book (The Essential Buffett), Buffett closed his first investment partnership in 1969 and paid out funds, for the reason that he found the market to be highly speculative and worthwhile value increasingly scarce (p 26). Buffett refers to the super-contagious diseases of fear and greed and says that he never tries to "anticipate the arrival and departure of either disease. Our goal is more modest: we simply attempt to be fearful when others are greedy and to be greedy only when others are fearful" – and his writings circa 1999 and 2000 clearly articulate a grave concern of irrational market exuberance. There are some brilliant observations about technology companies that only proves again, to me, that maturity and learning (Buffet has spades of both) are the only way to avoid such folly as we saw in this sector of the market in the late 20th century.

Buffet and BH are unique, and the lessons to be drawn from their philosophy and principles cannot be ignored – any serious investor, adviser or manager (corporate or fund) must study them, even if you do not agree with everything. Buffett's success is absolutely astounding, and anyone who reads the direct words of the maestro from this text will be better for it.

One caveat: the most important lesson for DIY investors (and perhaps for fund managers!) is that of the circle of competence. A reading of this book does not bring out fully, as is covered in other Buffett books, the history and degree of study and early experience in Buffett's life concerning investment. Buffett was quite literally born into stockbroking, he went to the best schools, had the very best teachers (ie, a happy coincidence of time, as he was there when they were), is gifted in maths and accounting, and has committed his entire life to corporate analysis and investing. Sure, you will gain insights, but this is no risk free path to replication.

Finally, it should be said, for those who do not wish to spend £11.50 (I bought this in England last year), you can go to the BH website www.berkshirehathaway.com, and you will find most of the writing there – eg, shareholders letters going back to 1977. However for a modest outlay, you get a good dissection into subject headings, and then collation under these discrete areas with footnote references, and you get the introduction and a useful index. Splash-out, save the printer, mark the text when reading it, and then revisit it one year later – the lessons will then sink in even further.

MARTIN EARP
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