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Security Analysis
Intelligent Inc.

The General Stock Market in 1960:

A year ago, I commented on the somewhat faulty picture presented in 1959 by the Dow-Jones Industrial Average which had advanced from 583 to 679, or 16.4%. Although practically all investment companies showed gains for that year, less than 10% of them were able to match or better the record of the Industrial Average. The Dow-Jones Utility Average had a small decline and the Railroad Average recorded a substantial one.

In 1960, the picture was reversed. The Industrial Average declined from 679 to 616, or 9.3%. Adding back the dividends which would have been received through ownership of the Average still left it with an overall loss of 6.3%. On the other hand, the Utility Average showed a good gain and, while all the results are not now available, my guess is that about 90% of all investment companies out-performed the Industrial Average. The majority of investment companies appear to have ended the year with overall results in the range of plus or minus 5%. On the New York Stock Exchange, 653 common stocks registered losses for the year while 404 showed gains.

Results in 1960:

My continual objective in managing partnership funds is to achieve a long-term performance record superior to that of the Industrial Average. I believe this Average, over a period of years, will more or less parallel the results of leading investment companies. Unless we do achieve this superior performance there is no reason for existence of the partnerships.

However, I have pointed out that any superior record which we might accomplish should not be expected to be evidenced by a relatively constant advantage in performance compared to the Average. Rather it is likely that if such an advantage is achieved, it will be through better-than-average performance in stable or declining markets and average, or perhaps even poorer than-average performance in rising markets.

I would consider a year in which we declined 15% and the Average 30% to be much superior to a year when both we and the Average advanced 20%. Over a period of time there are good

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 three's and par five's.

The above dose of philosophy is being dispensed since we have a number of new partners this year and I want to make sure they understand my objectives, my measure of attainment of these objectives, and some of my known limitations.

With this background it is not unexpected that 1960 was a better-than-average year for us. As contrasted with an overall loss of 6.3% for the Industrial Average, we had a 22.8% gain for the seven partnerships operating throughout the year. Our results for the four complete years of partnership operation after expenses but before interest to limited partners or allocation to the general partner are:

<u>Year</u>	<u>Partnerships Operating Entire Year</u>	<u>Partnership Gain</u>	<u>Dow-Jones Gain</u>
1957	3	10.4%	-8.4%
1958	5	40.9%	38.5%
1959	6	25.9%	19.9%
1960	7	22.8%	-6.3%

It should be emphasized again that these are the net results to the partnership; the net results to the limited partners would depend on the partnership agreement that they had selected.

The overall gain or loss is computed on a market to market basis. After allowing for any money added or withdrawn, such a method gives results based upon what would have been realized upon liquidation of the partnership at the beginning of the year and what would have been realized upon liquidation ~~of gains or losses~~ and is different, of course, from our tax results which value securities at cost and realize gains or losses only when securities are actually sold.

On a compounded basis, the cumulative results have been:

<u>Year</u>	<u>Partnership Gain</u>	<u>Dow-Jones Gain</u>
1957	10.4%	-8.4%
1958	55.6%	26.9%
1959	95.9%	52.2%
1960	140.6%	42.6%

Although four years is entirely too short a period from which to make deductions, what evidence there is points toward confirming the proposition that our results should be relatively better in moderately declining or static markets. To the extent that this is true, it indicates that our portfolio may be more conservatively, although decidedly less conventionally, invested than if we owned "blue-chip" securities. During a strongly rising market for the latter, we might have real difficulty in matching their performance.

Multiplicity of Partnerships:

A preceding table shows that the family is growing. There has been no partnership which has had a consistently superior or inferior record compared to our group average, but there has been some variance each year despite my efforts to keep all partnerships invested in the same securities and in about the same proportions. This variation, of course, could be eliminated by combining the present partnerships into one large partnership. Such a move would also eliminate much detail and a moderate amount of expense.

Frankly, I am hopeful of doing something along this line in the next few years. The problem is that various partners have expressed preferences for varying partnership arrangements. Nothing will be done without unanimous consent of partners.

Advance Payments:

Several partners have inquired about adding money

during the year to their partnership. Although an exception has been made, it is too difficult to amend partnership agreements during mid-year where we have more than one family represented among the limited partners. Therefore, in mixed partnerships additional interest can only be acquired at the end of the year.

We do accept advance payments during the year toward partnership interest and pay interest at 6% on this payment from the time received until the end of the year. At that time, subject to amendment of the agreement by the partners, the payment plus interest is added to the partnership capital and thereafter participates in profits and losses.

Sanborn Map:

Last year mention was made of an investment which accounted for a very high and unusual proportion (35%) of our net assets along with the comment that I had some hope this investment would be concluded in 1960. This hope materialized. The history of an investment of this magnitude may be of interest to you.

Sanborn Map Co. is engaged in the publication and continuous revision of extremely detailed maps of all cities in the United States. For example, the volumes mapping Omaha weigh perhaps fifty pounds and provide minute details on each structure. The map would be revised by the paste-over method showing new construction, changed occupancy, new fire protection facilities, changed structural materials, etc. These revisions would be done approximately annually and a new map would be published every twenty or thirty years when further paste-overs became impractical. The cost of keeping the map revised to an Omaha customer would run around \$100 per year.

This detailed information showing diameter of water mains underlying streets, location of fire hydrants, composition of roof, etc., was primarily of use to fire insurance companies. Their underwriting departments, located in a central office, could evaluate business by agents nationally. The theory was that "a picture was worth a thousand words" and such evaluation would decide whether the risk was properly rated, the degree of conflagration exposure in an area, advisable reinsurance

procedure, etc. The bulk of Sanborn's business was done with about thirty insurance companies although maps were also sold to customers outside the insurance industry such as public utilities, mortgage companies, and taxing authorities.

For seventy-five years the business operated in a more or less monopolistic manner with profits realized in every year accompanied by almost complete immunity to recession and lack of need for any sales effort. In the earlier years of the business, the insurance industry became fearful that Sanborn's profits would become too great and placed a number of prominent insurance men on Sanborn's board of directors to act in a watch-dog capacity.

In the early 1950's, a competitive method of underwriting known as "carding" made inroads on Sanborn's business and after-tax profits of the map business fell from an average annual level of over \$500,000 in the late 1930's to under \$100,000 in 1958 and 1959. Considering the upward bias in the economy during this period, this amounted to an almost complete elimination of what had been sizable, stable earning power.

However, during the early 1930's Sanborn had begun to accumulate an investment portfolio. There were no capital requirements to the business so that any retained earnings could be devoted to this project. Over a period of time about \$2.5 million was invested, roughly half in bonds and half in stocks. Thus, in the last decade particularly, the investment portfolio blossomed while the operating map business wilted.

Let me give you some idea of the extreme divergence of these two factors. In 1938 when the Dow-Jones Industrial Average was in the 100-120 range, Sanborn sold at \$110 per share. In 1958 with the Average in the 550 area, Sanborn sold at \$45 per share. Yet during that same period the value of the Sanborn investment portfolio increased from about \$20 per share to \$65 per share. This means, in effect, that the buyer of Sanborn stock in 1938 was placing a positive valuation of \$90 per share on the map business (\$110 less the \$20 value of the investment unrelated to the map business) in a year of depressed business and stock market conditions. In the tremendously more vigorous climate of 1958 the same map business was evaluated at a minus \$20 with the buyer of the stock unwilling to pay more than 70¢

on the dollar for the investment portfolio with the map business thrown in for nothing.

How could this come about? Sanborn in 1958 as well as 1938 possessed a wealth of information of substantial value to the insurance industry. To reproduce the detailed information they had gathered over the years would have cost tens of millions of dollars. Despite "carding," over \$500 million of fire premiums were underwritten by "mapping" companies. However, the means of selling and packaging Sanborn's product, information, had remained unchanged throughout the years and finally this inertia was reflected in the earnings.

The very fact that the investment portfolio had done so well served to minimize in the eyes of most directors the need for rejuvenation of the map business. Sanborn had a sales volume of about \$2½ million per year and owned about \$7 million worth of marketable securities. The income from the investment portfolio was substantial, the business had no possible financial worries, the insurance companies were satisfied with the price paid for maps, and the stockholders still received dividends. However, these dividends were cut five times in eight years and I could never find any record of suggestions pertaining to cutting salaries or director's and committee fees.

Prior to my entry on the Board, of the fourteen directors, nine were prominent men from the insurance industry who combined held 46 shares of stock out of 105,000 shares outstanding. Despite their top positions with very large companies which would suggest the financial wherewithal to make at least a modest commitment, the largest holding in this group was ten shares. In several cases, the insurance companies these men owned small blocks of stock but these were token investments in relation to the portfolios in which they were held. For the past decade the insurance companies had been only sellers in any transactions involving Sanborn stock.

The tenth director was the company attorney, who held ten shares. The eleventh was a banker with ten shares who recognized the problems of the company, actively pointed them out, and later added to his holdings. The next two directors were the top officers of Sanborn who owned about 300 shares combined. The officers were capable, aware of the problems of the business.

but kept in a subservient role by the Board of Directors. The final member of our cast was a son of a deceased president of Sanborn. The widow owned about 15,000 shares of stock.

In late 1958, the son, unhappy with the trend of the business, demanded the top position in the company, was turned down and submitted his resignation, which was accepted. Shortly thereafter we made a bid to his mother for her block of stock, which was accepted. At the time there were two other large holdings, one of about 10,000 shares (dispersed among customers of a brokerage firm) and one of about 8,000. These people were quite unhappy with the situation and desired a separation of the investment portfolio from the map business, as did we.

Subsequently our holdings (including associates) were increased through open market purchases to about 24,000 shares and the total represented by the three groups increased to 46,000 shares. We hoped to separate the two businesses, realize the fair value of the investment portfolio and work to re-establish the earning power of the map business. There appeared to be a real opportunity to multiply map profits through utilization of Sanborn's wealth of raw material in conjunction with electronic means of converting this data to the most usable form for the customer.

There was considerable opposition on the Board to change of any type, particularly when initiated by an "outsider," although management was in complete accord with our plan and a similar plan had been recommended by Booz, Allen & Hamilton, Management Experts. To avoid a proxy fight (which very probably would not have been forthcoming and which we would have been certain of winning) and to avoid time delay with a large portion of Sanborn's money tied up in blue-chip stocks which I didn't care for at current prices, a plan was evolved taking out all stockholders at fair value who wanted out. The SEC ruled favorably on the fairness of the plan. About 72% of the Sanborn stock, involving 50% of the 1,600 stockholders, was exchanged for portfolio securities at fair value. The map business was left with over \$1½ million in government and municipal bonds as a reserve fund, and a potential corporate capital gains tax of over \$1 million was eliminated. The remaining stockholders were left with a slightly improved asset value, substantially higher earnings per share, and an increased dividend rate.

Necessarily, the above little melodrama is a very abbreviated description of this investment operation. However, it does point up the necessity for secrecy regarding our portfolio operations as well as the futility of measuring our results over a short span of time such as a year. Such "control situations" may occur very infrequently. Our bread-and-butter business is buying undervalued securities and selling when the undervaluation is corrected along with investment in "special situations" where the profit is dependent on corporate rather than market action. To the extent that partnership funds continue to grow, it is possible that more opportunities will be available in "control situations."

The auditors should be mailing your financial statement and tax information within about a week. If you have any questions at all regarding either their report or this letter, be sure to let me know.

Warren E. Buffett
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