Berkshire Hathaway: A Successful Conglomerate and Not Just a Mutual Fund!

V. Sivarama Krishnan, University of Central Oklahoma
R. Barry Ellis, University of Central Oklahoma

ABSTRACT

Warren Buffett is acclaimed as one of the greatest investors of all time. Much of this acclaim is based on the performance of the common shares of Berkshire Hathaway, the firm run by Buffett. The firm's stock has returned an annualized return of over 21 percent since 1965 when Buffett took control of the firm. Reports of Buffett's investment prowess are also based on the performance of the equity portfolio held by Berkshire and Buffett and is compared with leading money and mutual fund managers. This paper attempts to answer a question that is seldom asked: Is Berkshire's success more due to its operating businesses than its equity portfolio? Berkshire is a classic conglomerate – meaning a firm, with a number of diversified and unrelated businesses - and a very successful one. It is a holding company with over 60 subsidiary operating businesses and has used the internal capital market and conglomerate strategy very successfully. It has grown by acquisitions and during the last 40 years, the firm has acquired a number of businesses ranging from insurance to bricks to furniture stores and jewelry. Surplus cash from slow growth businesses are used to fund high growth businesses. We look at Berkshire's operating results as well as the equity portfolio performance over the last 2 decades in order to answer the above question. There is evidence that Berkshire has done very well with its operating businesses and it is no exaggeration to say that Berkshire's acquisitions strategy is as much a force behind the firm's success as its passive stock portfolio. Buffett has delivered more value as a corporate manager than as a money manager and stock picker. While the investment portfolio has certainly added value to the firm, more of the value added has come from the many operating units that Berkshire acquired and successfully integrated into the firm.

INTRODUCTION

Warren Buffett is often hailed as one of the greatest investors of all time. This acclaim is based on the performance of the common shares of Berkshire Hathaway (Berkshire), the firm managed by Buffett. Buffett, as Chairman and CEO and his close associate, Charles Munger[1], as Vice-Chairman, have guided Berkshire to enormous prosperity and enriched the shareholders. One share of Berkshire Hathaway was trading at about $18 in 1965 (Statman and Scheid (2002)) when Buffett took control of what was then an ailing textile business. The firm's most recent stock price (as of February 4, 2010) is about $105,000. This amounts to an amazing annualized compound return of over 21 percent over a 45-year period. The firm became an insurance company soon after Buffett's acquisition and has invested part of its cash flows into equities that are widely traded in the stock market. The investment portfolio of Berkshire has contributed greatly to the firm's success and has always attracted a lot of attention. Research has shown that this portfolio has earned annualized returns far exceeding that of benchmarks like the S&P 500 (Martin and Puthenpurackal (2007)). The investment gains from Berkshire's equity, however, are not the only, and perhaps not even the main, reason for the astounding returns earned by Berkshire stockholders. This paper focuses on the untold story about the other and far bigger part of Berkshire's asset portfolio - the firm's 60 plus operating businesses, which have been acquired over the last four decades and have been managed with skills rarely seen in the corporate world. Buffett and Munger have created a very successful and large conglomerate that is rarely mentioned in the many articles and books that have been published about Buffett and Berkshire. Even more important is the fact that Buffett (and Munger; hereafter the references to Buffett can be taken to mean the duo) has made an outstanding success of a corporate business model – the conglomerate diversification model - that has been somewhat discredited on account of the poor performance of the firms that tried the approach in the 1970s and 1980s (Lang and Stulz (1994), Berger and Ofek (1995)).

Berkshire is a classic conglomerate – meaning a firm, with a number of diversified and unrelated businesses - and a very successful one. It is a holding company with over 60 subsidiary operating businesses and has used the internal capital market strategy very successfully. It has grown by acquisitions and during its history of over 40 years the firm has acquired a number of businesses ranging from insurance to bricks to furniture stores and jewelry. The business model adopted by Berkshire is simple: Surplus cash flow from low growth businesses are used to fund high growth businesses and acquisition of other businesses or stock market investment. Again, while Berkshire's stock market investment has attracted all the attention, the acquisition of whole businesses and more importantly the very successful integration of these businesses into the Berkshire family have drawn little notice except when it involves some really large scale acquisition of a firm that is publicly traded as the recent case of Burlington Northern Santa Fe Corporation (BNSF). The success of Berkshire's conglomerate strategy has rarely been the focus of academic studies while the success of the investment portfolio has garnered most of the attention. There appears to be a widespread belief that Buffett's and Berkshire's success is primarily driven by the firm's equity investment portfolio. However, the equity portfolio of passive investments forms less than 20 percent of the market value of the firm.

This paper attempts to answer a question that has been seldom asked: Is Berkshire's success due more to its operating businesses than to its equity portfolio? We look at Berkshire's operating results as well as the equity portfolio performance over the last 15 years in order to answer the above question. There is evidence that Berkshire has done very well with its operating businesses and it is no exaggeration to say that Berkshire's acquisitions strategy is the dominant force behind the firm's success. In other words, Buffett has delivered more value as a corporate manager than as a money manager. While the investment portfolio has certainly added value to the firm and the portfolio performance has been excellent, more of the value added has come from the many operating units that Berkshire acquired and successfully integrated into the firm.

The paper is organized as follows. The next section provides a short history of Berkshire and a brief description of its current operating businesses. This is followed by a review of the relevant literature that has featured Berkshire and Buffett. The next section describes our analysis of Berkshire's performance and its business model. The concluding section summarizes our findings.

A SHORT HISTORY OF BERKSHIRE HATHAWAY

Buffett started his investing career in the early 1950s working for the famous investor and his teacher, Columbia University professor Benjamin Graham. He moved back to his native Omaha, Nebraska in 1956 and started several investment partnerships, which were all very successful and formed the foundation for later successful investments. His own initial investment in each partnership was $100, but he was compensated for his efforts through a substantial share of the profits. These partnerships did very well for Buffett and his partners. Buffett acquired control of Berkshire Hathaway, an ailing New England textile business, in May 1965 after accumulating the shares of the company through a series of purchases in the market over a period of several months. The textile business was, perhaps, one of the less than stellar investments of Buffett. In 1966, he started an investment holding company called Diversified Retailing Company (DRC) with Charlie Munger and David Gottesman to acquire a Baltimore retailer (Schroeder (2008)). This company was used to acquire several other privately owned businesses and as a conduit for investments in the stock market. Berkshire was also used as an investment vehicle and Buffett entered the insurance business in 1967 by purchasing Nebraska Indemnity Company and National Fire and Marine Insurance Company. All this was done through Berkshire Hathaway and DRC. Buffett also invested in Blue Chip Stamps through Berkshire and DRC. Over time, Berkshire acquired full ownership of Blue Chip Stamps and DRC and Blue Chip Stamps were merged into Berkshire Hathaway.

Property and casualty insurance became the "core" business of Berkshire as the textile business withered and the New England operations were closed down. Today the insurance business, both direct and re-insurance, remains Berkshire's core business and is conducted through a number of subsidiaries. The insurance business allows cash float both through prepaid premiums and delayed claims on incurred losses. This cash float plus the operating cash flows generated through the increasing number of non-insurance subsidiaries have allowed Buffett and Munger to expand their portfolio of both passive stock ownership and 100 percent ownership of a variety of businesses in all types of industries. The number of non-insurance operating subsidiaries runs into more than 60 as of the end of 2009. The annual report for 2008 provides the following grouping and summary description of Berkshire's businesses. This grouping is used for segment data given in the annual report and summarized in Tables 1 and 2 (Berkshire-Hathaway Annual Report 2008).

Insurance group includes GEICO, General Re, Berkshire Hathaway Reinsurance group and Berkshire Hathaway Primary group.

Finance and financial products group includes BH Finance, Clayton Homes, XTRA, CORT and other financial services and do the following: Proprietary investing, manufactured housing and related consumer financing, transportation equipment leasing, furniture leasing, life annuities and risk management products.

Marmon is an association of approximately 130 manufacturing and service businesses that operate within 11 diverse business sectors. Berkshire acquired 63.4 % of this group in 2008 and is required to buy the remaining ownership in stages between 2011 and 2014.

McLane Company does wholesale distribution of groceries and non-food items.
MidAmerican is a regulated electric and gas utility and does power generation and distribution activities in the U.S. and internationally.
Shaw Industries' business includes manufacturing and distribution of carpet and floor coverings under a variety of brand names.

Other businesses include manufacturing; service and retailing are as given below:

Manufacturing:	Acme Building Brands, Benjamin Moore, H.H. Brown Shoe Group, CTB, Fechheimer Brothers, Forest River, Fruit of the Loom, Garan, IMC, Johns Manville, Justin Brands, Larson-Juhl, MiTek, Richline, Russell and Scott Fetzer
Service:	Buffalo News, Business Wire, FlightSafety, International Dairy Queen, Pampered Chef, NetJets and TTI
Retailing:	Ben Bridge Jeweler, Borsheims, Helzberg Diamond Shops, Jordan's Furniture, Nebraska Furniture Mart, See's, Star Furniture and R.C. Willey

It should be mentioned that the grouping given above is purely for summary reporting purposes and in no way reflects any kind of operational tie-ups. Each business is managed as independent and autonomous units reporting to the Chairman (Buffett). It is remarkable that Buffett has never even thought, except perhaps in insurance business, of exploiting any kind of operating synergies across business units in similar or related industries. We believe that this approach to managing diversification is as much a factor in the huge success of Berkshire as the intuitive stock-picking genius of Buffett. We have to more to say about this later in the paper.

REVIEW OF LITERATURE

Buffett and Berkshire have attracted a lot of attention over the years on account of the excellent performance of the Berkshire stock and the superior returns earned by the stock portfolio held by Berkshire. Buffett has earned a reputation for his investing prowess for the same reasons. Several biographies of Buffett have been published extolling his virtues in general and investing acumen in particular. Lowenstein (1995) is a good example. Schroeder (2008) has an even more exhaustive work detailing all aspects of Buffett's career as well as his unique personality and business and personal relationships. There have been a number of media articles chronicling the remarkable investment success of Buffett and Berkshire (see Seligman (1983) and Updegrave (1987), for example). Hagstrom (2004) attempts to capture Buffett's investment skills and insights through analyzing the equity portfolios of Berkshire. Another genre of literature spawned by the success of Buffett is the one which purports to show the wisdom and managerial insights of Buffett. There are several books which have reproduced or produced annotated versions of Buffett's famous annual letters to shareholders.

The performance of Berkshire has been phenomenal and very consistent. Statman and Scheid (2002) show that from 1965 till 2000 the annualized return for Berkshire stock was a astonishing 26 percent compared to the 11.7 percent earned by the Standard and Poor (S&P) 500 index. However, Statman and Scheid (2002) also note that during the period 1976 to 2000, shares of seven other companies performed better than Berkshire. This list of superior performers included Mylan Labs, Applied Materials, Home Depot and Wal-Mart. Martin and Puthenpurackal (2007), in a detailed study look at the performance of the equity investment portfolios held by Berkshire. The annual average return for the Berkshire portfolios during the period of 1976 to 2006 was almost 25 percent compared to S&P 500 return of 10.32 percent. The compounded annual return works out to about 21.6 percent. One should note that during the same period, Berkshire stock actually did even better with a compounded return of 26.9 percent. Martin and Puthenpurackal (2007) also show that the Berkshire equity portfolio's performance was far superior to other benchmarks such as a value weighted index and a Fama & French size and book-to-market equity ratio adjusted portfolio of 25 stocks. It should be mentioned that neither Statman and Scheid nor Martin and Puthenpurackal analyze the operating assets of Berkshire. As far as we know, the general impression one gets from almost all of the writings about Berkshire and Buffett is that the enormous success and value added to the Berkshire stock has come from the equity portfolio investments made by Buffett and Berkshire.

Zeckhauser (2007) credits Buffett with unique insights and skills that help him invest in events or assets with *unknown* and *unknowable* features or elements. He cites examples of Berkshire's unique and successful insurance underwriting with possible, but remote, risk of billion dollar losses. This skill goes beyond what the typical successful investor/money manager deals with or would want to deal with. We believe that Buffett (with Munger) showed a unique talent in seizing these opportunities in insurance and other markets and accumulated a vast portfolio of assets that are not available to a typical mutual fund manager. This asset portfolio of operating businesses has enabled Berkshire to turn in a performance far superior to even the excellent performance of its own choice equity portfolio.

BERKSHIRE'S OPERATING ASSETS AND BUSINESS MODEL

While Buffett and Berkshire have been in the news mostly for the equity stock portfolio, for over a period of 45 years the company has accumulated, without much fanfare, a truly diversified portfolio of operating businesses. A listing of these businesses was given earlier. Table 1 gives revenues, earnings before taxes and minority interests,[2] capital expenditures and assets. The total revenues exceeded $115 billion in 2008 and profits before taxes exceeded $15 billion. The insurance group is the largest by revenues and profits, but requires little capital expenditures. The insurance business also generates a lot of *float*, which is described by Buffett as follows in the 1995 annual report.

> "Float is money we hold but don't own. In an insurance operation, float arises because most policies require that premiums be prepaid and, more importantly, because it usually takes time for an insurer to hear about and resolve loss claims. Typically, the premiums that an insurer takes in do not cover the losses and expenses it must pay. That leaves it running an "underwriting loss" and that loss is the cost of float. An insurance business is profitable over time if its cost of float is less than the cost the company would otherwise incur to obtain funds. But the business has a negative value if the cost of its float is higher than market rates for money."

Berkshire’s insurance business did very well in terms of float and generated a lot of cash at little to no costs. This has helped the business enormously.

Table 2 gives selected ratios for the operating businesses. All the business segments generated profits. Insurance, financial products, and MidAmerican (electric and gas utility) are among the most profitable. MidAmerican appears to be the only group that needs large capital expenditures. These capital needs are more than met by the profits generated by other businesses. For 2008, cash flows from operations were $11.3 billion. Capital expenditures for the operating businesses were $6.1 billion leaving over $5 billion for net new investments. This is the typical pattern for Berkshire as the operating businesses collectively generate large amounts of free cash flows.

Buffett and Munger have stressed owner orientation. Here are some illuminating quotes from the 1995 annual report, which are as valid today they were in the 70s or 80s. These sentences also explain not only the business model of Berkshire but also its main strength:

> “Our preference would be to reach this goal (of maximizing Berkshire’s intrinsic business value) by directly owning a diversified group of businesses that generate cash and consistently earn above-average returns on capital. Our second choice is to own parts of similar businesses, attained primarily through purchases of marketable common stocks by our insurance subsidiaries. The price and availability of businesses and the need for insurance capital determine any given year's capital allocation.”
>
> “Charlie Munger, Berkshire's Vice Chairman and my partner, and I want to build a collection of companies both wholly-and partly-owned that has excellent economic characteristics and that are run by outstanding managers. Our favorite acquisition is the negotiated transaction that allows us to purchase 100% of such a business at a fair price. But we are almost as happy when the stock market offers us the chance to buy a modest percentage of an outstanding business at a pro-rata price well below what it would take to buy 100%. This double-barreled approach purchases of entire businesses through negotiation or purchases of part-interests through the stock market give us an important advantage over capital-allocators who stick to a single course.”

Since the mid-1990s, more of the investments have been in 100 percent wholly owned businesses resulting in more than 60 operating units. As stated before, these operating businesses have contributed more to Berkshire’s value than the widely written about equity portfolio. Figure 1 captures the relatively significance of the equity portfolio in Berkshire’s value over time. The market value of equity portfolio is shown as a percentage of the book value of total assets, market value of total assets and market value of shareholders’ equity. While the equity portfolio was 43 percent of total market value in 1995, the ratio fell to 15.9 percent in 2008. Table 3 shows the equity portfolio values, total book value of assets, market value, and market value added for operating businesses. Selected ratios of the equity portfolios to different bases are also given. For 2008, the market value added for the operating businesses is $40 billion. Market value added for the equity portfolio (market value – cost) has also decreased in relative importance since the mid 1990s.

Berkshire's business model can be considered a classic conglomerate strategy anchored by its core business of insurance. What is remarkable and less discussed about this strategy is the amazing efficiency with which Buffett and his corporate team comprising Charlie Munger and a few, very few, staffers at the corporate headquarters in Omaha manage all corporate affairs and the capital allocation. While the total number of Berkshire employees adds up to over 230,000, the corporate headquarters have a staff of only 19 (at the end of 2008). All the operating decisions are made by the heads of the business units. All the capital expenditures and capital allocation decisions are made by Buffett and Munger. In other words, Berkshire operates as an internal capital market. Here are some more quotes from the 1995 annual reports that highlight two key advantages Berkshire has:

> "First, our operating managers are outstanding and, in most cases, have an unusually strong attachment to Berkshire. Second, Charlie and I have had considerable experience in allocating capital and try to go at that job rationally and objectively."
>
> "In making acquisitions, we have a further advantage: As payment, we can offer sellers a stock backed by an extraordinary collection of outstanding businesses. An individual or a family wishing to dispose of a single fine business, but also wishing to defer personal taxes indefinitely, is apt to find Berkshire stock a particularly comfortable holding."

The last quote, perhaps, explains the regularity with which Berkshire has been able to acquire a number of excellent, privately owned businesses. The collective tax savings provided by Berkshire's internal capital market strategy is one of the key advantages it has enjoyed and continues to enjoy.

Berkshire's business model keeps all the operating businesses the way they were when they were acquired with no attempt to link any of the value chains or exploit any perceived operating synergies. This keeps the overall organizational structure simple with all the operating unit heads reporting directly to Buffett. This has made Berkshire's unrelated diversification or conglomerate strategy a remarkable success not often seen elsewhere in corporate world.

CONCLUDING COMMENTS

This paper focused on the less told story of the operating side of Berkshire Hathaway, a company whose success is often attributed to the investing prowess of its Chairman, Warren Buffett. While Buffett's investing skills are not disputed and have definitely contributed to the success of Berkshire, the shareholders of Berkshire have also benefited from the array of successful operating businesses that were acquired and operated very successfully. Today, the operating assets account for over 80 percent of the market value of Berkshire. Buffett and his able partner and vice-Chairman, Charlie Munger have made a tremendous success of the much maligned conglomerate model by operating the firm as an efficient internal capital market. It can be stated without any doubt that Buffett and Munger are as good managers as they are investors. They have managed very well the vast array of diversified businesses that Berkshire owns even as they keep adding more new businesses each year. Here is at least one example of a company that has added enormous value with diversification.

ENDNOTES

[1]Munger should be considered an equal part of the management team deserving credit as much as Buffett, who has been the more visible partner.

[2] Minority interests are material only for one segment, Marmon, which is 64 percent owned by Berkshire.

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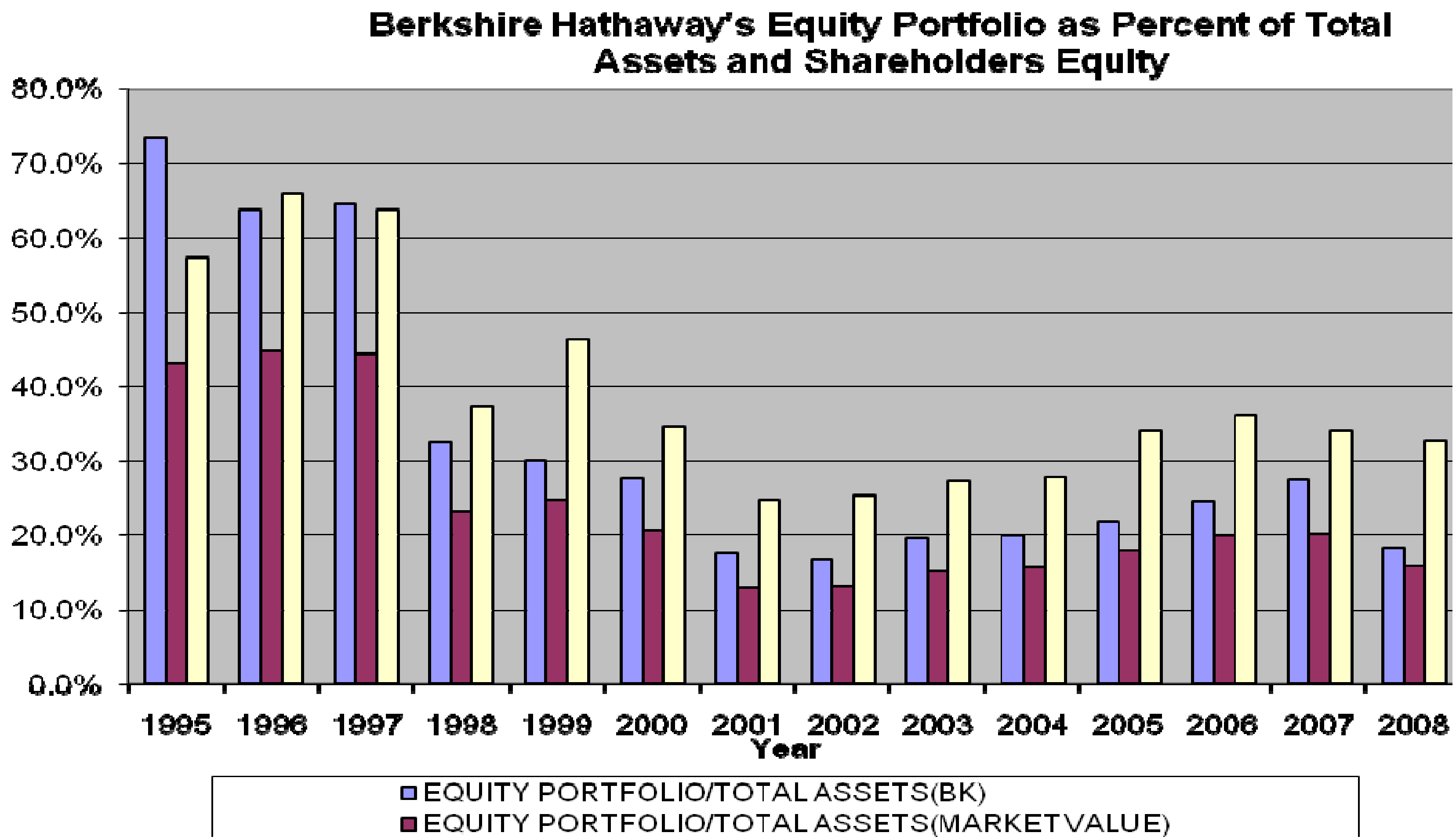
Berkshire Hathaway's Equity Portfolio as Percent of Total Assets and Shareholders Equity
80.0%
70.0%
60.0%
50.0%
40.0%
30.0%
20.0%
10.0%
0.0%
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
Year
EQUITY PORTFOLIO/TOTAL ASSETS(BK)
EQUITY PORTFOLIO/TOTAL ASSETS(MARKET VALUE)

Figure 1

Table 1: BERKSHIRE - SEGMENT INFORMATION 2007-2008

$ In Millions

BUSINESS SEGMENT	REVENUES		EARNINGS BEF. TAXES & MIN. INTERESTS		CAPITAL EXPENDITURES		IDENTIFIABLE ASSETS AT YEAR END	
	2008	2007	2008	2007	2008	2007	2008	2007
Insurance group	30,284	36,574	7,514	8,132	72	52	133,236	146,938
Finance and financial products	4,947	5,119	787	1,006	185	322	22,918	24,733
Marmon	5,529	-------	733	-------	553	-------	9,757	-------
McLane Company	29,852	28,079	276	232	180	175	3,477	3,329
MidAmerican	13,971	12,628	2,963	1,774	3,936	3,513	36,290	33,645
Shaw industries	5,052	5,373	205	436	173	144	2,924	2,922
Other Businesses	25,666	25,648	2,809	3,279	1,039	1,167	21,323	20,579
Total	115,301	113,421	15,287	14,859	6,138	5,373	229,925	232,146

TABLE 2: SEGMENT INFORMATION – SELECTED RATIOS

BUSINESS SEGMENT	PROFIT MARGIN		RETURN ON ASSETS		CAPEX/REVENUES		CAPEX/ASSETS	
	2008	2007	2008	2007	2008	2007	2008	2007
Insurance group	24.8%	22.2%	5.6%	5.5%	0.2%	0.1%	0.1%	0.0%
Finance and financial products	15.9%	19.7%	3.4%	4.1%	3.7%	6.3%	0.8%	1.3%
Marmon	13.3%	…	7.5%	….	10.0%	….	5.7%	
McLane Company	0.9%	0.8%	7.9%	7.0%	0.6%	0.6%	5.2%	5.3%
MidAmerican	21.2%	14.0%	8.2%	5.3%	28.2%	27.8%	10.8%	10.4%
Shaw industries	4.1%	8.1%	7.0%	14.9%	3.4%	2.7%	5.9%	4.9%
Other Businesses	10.9%	12.8%	13.2%	15.9%	4.0%	4.6%	4.9%	5.7%
Total	13.3%	13.1%	6.6%	6.4%	5.3%	4.7%	2.7%	2.3%

TABLE 3: EQUITY PORTFOLIO AND SELECTED RATIOS

$ IN MILLIONS

Year	1995	1998	2001	2004	2005	2006	2007	2008
Equity Portfolio At Market Value						61,533		49,073
Equity Portfolio Value at cost	5,745	7,044	8,543	9,056	15,947	22,995	39,252	37,135
Market value added by Equity Portfolio	16,255	30,221	20,132	28,661	30,774	38,538	35,747	11,938
Total Assets (Book Value)						248,437		267,399
Shareholders' Equity (Book Value)						108,419		109,267
Shareholders' Equity (Market Value)	38,295	106,295	115,533	135,257	136,539	169,676	219,153	149,656
Total Assets (Market Value)						309,694		307,788
Equity Portfolio/Total Assets(Book value)	73.5%	32.5%	17.6%	20.0%	21.8%	24.8%	27.5%	18.4%
Equity Portfolio/Total Assets(Market Value)	43.2%	23.2%	13.0%	15.8%	18.0%	19.9%	20.2%	15.9%
Equity Portfolio/Market Value Of Sh. Equity	57.4%	37.4%	24.8%	27.9%	34.2%	36.3%	34.2%	32.8%
Change Market Value Of Equity	59.4%	87.2%	6.6%	4.5%	0.9%	24.3%	29.2%	-31.7%
Total Assets (Market Value) - Equity Portfolio	28,972	131,368	191,660	200,514	212,702	248,161	296,581	258,715
Market Value Added - Operating Businesses	21,043	48,892	57,583	49,357	45,055	61,257	98,420	40,389
MV added Op. Business/MV added Equity	1.29	1.62	2.86	1.73	1.46	1.59	2.75	3.38