

# Warren Buffett's Ground Rules



# Warren Buffett's Ground Rules



Words of Wisdom from the Partnership  
Letters of the World's Greatest Investor

JEREMY MILLER



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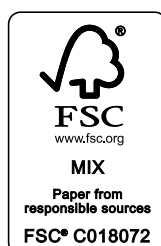
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Dedicated to the memory of my dear friend and  
colleague, Peter Sauer (1976-2012). Peter, you left us all too  
early. While you were here, your many great achievements  
were equaled only by your humbleness.

|||||



The excerpts from Warren Buffett's Partnership Letters are being used with his permission.

*Mr. Buffett has had no other connection with this book whatsoever.* In other words, while all the wisdom is his, all the errors are mine.

To maintain the narrative flow of the excerpts, omissions are not always indicated.<sup>1</sup>





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# INTRODUCTION

**“If I was running \$1 million, or \$10 million for that matter, I’d be fully invested. The highest rates of return I’ve ever achieved were in the 1950’s. I killed the Dow. You ought to see the numbers. But I was investing peanuts back then. It’s a huge structural advantage not to have a lot of money. I think I could make you 50% a year on \$1 million. No, I know I could. I guarantee that.”<sup>1</sup>**

—WARREN BUFFETT, *BUSINESSWEEK*, 1999

In 1956, Warren Buffett was working in New York with his mentor, value investing's founder, Benjamin Graham. When Graham decided to retire, he offered his best student a stake in his partnership, Graham-Newman, but the twenty-five-year-old Buffett opted to return home instead. Not long after, at the bequest of four family members and three friends, a new investment partnership—Buffett Associates, Ltd.—was formed. Before agreeing to accept their checks, however, he asked them to meet him for dinner at the Omaha Club. Everyone went Dutch.<sup>2</sup>

That night, Buffett handed each of them a few pages of legal documents containing the formal partnership agreement and suggested they not worry too much about what was in them; he assured them there would be no surprises. The gathering was intended to discuss something he considered much more important: the Ground Rules. He had made carbons of this short list of precepts and carefully went through each point. Buffett insisted on complete autonomy. He was not going to talk about what the Partnership was actually

doing; he gave very little detail on his actual holdings. He told them, “These ground rules are the philosophy. If you are in tune with me, then let’s go. If you aren’t, I understand.”<sup>3</sup>

## The Ground Rules

---

1. In no sense is any rate of return guaranteed to partners. Partners who withdraw one-half of 1% monthly are doing just that—withdrawing. If we earn more than 6% per annum over a period of years, the withdrawals will be covered by earnings and the principal will increase. If we don’t earn 6%, the monthly payments are partially or wholly a return of capital.
2. Any year in which we fail to achieve at least a plus 6% performance will be followed by a year when partners receiving monthly payments will find those payments lowered.
3. Whenever we talk of yearly gains or losses, we are talking about market values; that is, how we stand with assets valued at market at yearend against how we stood on the same basis at the beginning of the year. This may bear very little relationship to the realized results for tax purposes in a given year.
4. Whether we do a good job or a poor job is not to be measured by whether we are plus or minus for the year. It is instead to be measured against the general experience in securities as measured by the Dow-Jones Industrial Average, leading investment companies, etc. If our record is better than that of these yardsticks, we consider it a good year whether we are plus or minus. If we do poorer, we deserve the tomatoes.
5. While I much prefer a five-year test, I feel three years is an absolute minimum for judging performance. It is a certainty that we will have years when the partnership performance is poorer, perhaps substantially so, than the Dow. If any three-

year or longer period produces poor results, we all should start looking around for other places to have our money. An exception to the latter statement would be three years covering a speculative explosion in a bull market.

6. I am not in the business of predicting general stock market or business fluctuations. If you think I can do this, or think it is essential to an investment program, you should not be in the partnership.

7. I cannot promise results to partners. What I can and do promise is that:

- a. Our investments will be chosen on the basis of value, not popularity;
- b. That we will attempt to bring risk of permanent capital loss (not short-term quotational loss) to an absolute minimum by obtaining a wide margin of safety in each commitment and a diversity of commitments; and
- c. my wife, children and I will have virtually our entire net worth invested in the partnership.<sup>4</sup>

Everyone invited to the Omaha Club that night signed on and Buffett took their checks. As new partners joined, they were each carefully taken through the ground rules. Then, every partner was sent an updated copy annually.

Over the years that followed, Buffett communicated his performance and described his activities through a series of letters to this small but growing band of followers. He used them as a teaching tool to reinforce and expand upon the concepts behind the ground rules, discuss his expectations for future performance, and make comments about the market environment. At first these were annual updates but when enough partners griped that “a year was a long time between drinks,” he began writing at least semi-annually.

These “Partnership Letters” chronicle his thoughts, approaches, and reflections in the period immediately prior to his better-known

tenure at Berkshire Hathaway; it was a period that delivered an unprecedented record of investing success, even when compared to his track record at Berkshire. While he expected to have good years and bad, he thought that a 10% advantage to the Dow was achievable over most 3–5 year periods and that’s what he set to do.

He did far better. He consistently beat the market and never had a down year. For the entire period, he compounded partners’ capital at nearly a 24% annual rate, after fees. This earlier period produced many of the best performance years of his career.

The lessons that come out of this commentary offer timeless guidance for every type of investor—from beginners and amateurs to sophisticated pros. They lay forth a consistent and highly effective set of principles and methods that avoid the trendy and technical temptations abundant in today’s (or any day’s) market. While they do contain the type of sophisticated analysis that should appeal to seasoned professionals, the letters also are Buffett’s take on Investing 101—they provide a basic, commonsense approach that should resonate with everyone.

The Partnership Letters and their wisdom have been compiled comprehensively and accessibly for the first time in this book and include such bedrock principles as his contrarian diversification strategy, his almost religious celebration of compounding interest, and his conservative (as opposed to conventional) decision-making process. They also include his methods for investing in Generals, Workouts, and Controls, his three principal “methods of operation,” which evolved in interesting and important ways over time, ways that we’ll explore.

Essentially, the letters have tremendous value because they describe the mindset of a successful young investor working initially with very modest sums—a mindset that investors can adopt and use to achieve long-term success as they venture into the market themselves. They make a powerful argument for a long-term value-oriented strategy, one that is especially viable in turbulent times such as our own, when people are vulnerable to a speculative, oftentimes leveraged, short-term focus that is rarely effective in the long run.

They provide timeless principles of conservatism and discipline that have been the cornerstone of Buffett's success.

If a young Buffett were starting his Partnership today, there is little doubt he would achieve the same tremendous results. In fact, he's in print "guaranteeing" that he could earn 50% annual returns on just a few million dollars today. This high rate of return (on a small sum) would be just as feasible now as it was years ago because market inefficiencies remain, especially in smaller, less-followed businesses and because he's a brilliant investor; however, as long as stocks continue to have short memories, oscillating in value because of fear and greed, opportunities for terrific returns will always exist for all enterprising investors who can adopt the proper mindset.

As much as ever, many today lack the steadfastness to stay true to the discipline that value investing requires. In letter after letter, Buffett returns to the unchanging nature of his principles. It's an attitude-over-IQ approach—staying true to one's process without getting drawn in by the trends is one of the hardest things for even the most seasoned investors. Everyone can learn from Buffett's mastery of his own investment emotions.

Each chapter in this book is organized around a single idea or theme from the letters and follows the same basic format, starting with a summary essay intended to provide some of the backstory. Hopefully this will add historical context and allow for a fuller appreciation of the relevance of the content in our time.

Then all the critical excerpts from the letters on each topic are presented in full. This not only allows for "long drinks" from the well of Buffett's own writing but should also allow the book to be a useful reference tool for sourcing his work from this period. Aggregating all the commentary on a given topic in its own chapter is often revealing. We can see various patterns emerge over multiple letters where he's revisiting certain ideas and track the progression of his thinking, something that can be more difficult to pick up on when the letters are read chronologically.

Buffett has never published a textbook on investing, at least in the traditional sense of the word. What we do have, in addition to

the articles he's written and the notes that have been taken from his talks and speeches, are his letters. In effect these represent a correspondence course that has continued from 1957 to this day, the entire length of his career. The Partnership Letters represent the first section in that course, and I'm delighted to be sharing them with you. I hope you enjoy reading them as much as I have enjoyed putting them together.

I am grateful to Mr. Buffett for entrusting me in the use of his letters in this book and note once again that he wasn't otherwise involved in this project. I've aimed to present his material in a manner that I hope he approves of and in a way that makes his teaching accessible to emerging investors and seasoned professionals alike.



# Part I





# CHAPTER 1

# ORIENTATION

**“The availability of a quotation for your business interest (stock) should always be an asset to be utilized if desired. If it gets silly enough in either direction, you take advantage of it.”<sup>1</sup>**

—JULY 12, 1966

Picture yourself in Omaha, Nebraska: It is early one evening in the fall of 1956. Elvis just debuted on *The Ed Sullivan Show* and Eisenhower is in the White House. Tonight, you and twenty other adults are filing into a classroom at the University of Nebraska Omaha for the first lecture in a course called “Investment Principles.” Your teacher will be a twentysomething named Warren Buffett. As it turns out, you’ve chosen the seat next to Buffett’s Aunt Alice, one of the original seven investors in his first partnership.

I like to think of this book, in its own way, as a re-creation of that early “Investing Principles” class, drawing on the lessons he taught in the Partnership Letters that were written during the very time this course was offered. It’s your annotated guide to the basics of intelligent investing, as told through the key excerpts from almost forty of these early letters. These were the pre-Berkshire years, 1956 to 1970, a time when his capital was modest and his opportunity

set was unbounded. It was a time, especially in the early days of the Partnership, when he was most like you and me in that he was able to invest in nearly everything, when no companies were too small for him to be interested.

Buffett, while investing during the day, really did teach an evening class throughout the late 1950s and 1960s and his Aunt Alice, along with a few other eventual partners, really did attend his class. After completing Dale Carnegie's course to overcome his discomfort with public speaking, Buffett taught as a way to keep up his skills. Not only that, but he was following the example of his mentor, Ben Graham, who in addition to writing letters to his investors also taught a course on securities analysis at Columbia Business School, while running Graham-Newman, his investment company.

## The Bedrock Principles of Benjamin Graham

There is no better place to start a book on basic intelligent investing than with the foundational tenet of Buffett's general thinking, one that's universally shared by Graham's disciples: The market can and will at times be completely deranged and irrational in the *short term*, but over the *long term* it will price securities in line with their underlying intrinsic values.

Buffett uses his mentor's somewhat paradoxical idea as a teaching tool throughout the letters because it so effectively distinguishes what we're actually after as investors: consistently sound, rational business analysis based on logic and good reasoning that leads to the selection of securities offering the highest potential return with the lowest possible amount of corresponding risk. That's the long-term investor's approach, and it's a very different approach from trying to generate gains by speculating on what other investors will or will not do or by making guesses around short-term changes in macro variables like oil prices or interest rates. Investors, as we'll come to define the term, buy businesses; speculators "play" markets.

Investors learn to see short-term gyrations in stock prices as basically random squiggles and believe they can be largely ignored; then, because they are seen as random, no attempt is made to systematically predict them. This is simply not our game.

Over the long term, however, markets do tend to get it right and ultimately reflect the economic experience of a business into the price of its stock. Knowing this, investors therefore focus on solid long-term business analysis and conservative reasoning—that's what we believe leads to above-average results over time.

This big, foundational principle comes directly from Ben Graham, Buffett's teacher, former employer, hero, and the man who practically invented securities analysis. Known as the Dean of Wall Street, Ben Graham was a revolutionary, the first to turn what had formerly been somewhat of a "dark art" into a real profession. Buffett was consumed by Graham's ideas from the moment he encountered them—so much so that he even named his son, who is in line to become the next nonexecutive chairman of Berkshire Hathaway, Howard *Graham* Buffett. Grasping Buffett's investing principles, the part that's remained constant from the Partnership years all the way through to the present day, requires a firm understanding of several of Graham's foundational ideas and influences. Here's how it all began:

Buffett graduated a year early from the University of Nebraska–Lincoln in 1950 at the age of nineteen. He then applied to Harvard Business School but was told he would have a better chance if he re-applied in a few years. Getting turned down by Harvard was one of the luckiest things that ever happened to him. As he began looking at other business schools, he came across Columbia's catalog. In it, he discovered that the author of his favorite book, *The Intelligent Investor*, was not only alive but also teaching there. Buffett immediately applied. Several weeks later (he applied in August) he was enrolled at Columbia and not too long after that he was sitting in Graham's classroom as the star pupil. One can only imagine the intensity of the intellectual dynamic between these two men. Graham was laying Buffett's intellectual foundation and Buffett, the only

student to get an A-plus, was picking up on everything Graham was putting down.<sup>2</sup>

After graduation, Buffett was absolutely desperate to work for Graham's investment company, but, as he later joked, he was turned down for being "overvalued" despite an offer to work for free.<sup>3</sup> The real reason he didn't get the job was probably more linked to Graham-Newman being one of only a few Jewish-owned investment companies; Buffett could get a good job elsewhere but other highly qualified Jews, if turned down by Graham, might be otherwise shut out.<sup>4</sup>

Disappointed, he returned to Omaha to join his dad in the securities brokerage business, where he continued pursuing the idea of working with Graham. A three-year steady stream of letters and stock ideas was all it took; his mentor finally relented and invited him back to New York in 1954.<sup>5</sup> Buffett didn't get much time at Graham-Newman, though—a year after he joined, Graham decided to retire.

Once again, now at the age of twenty-five, Buffett returned to Omaha, although this time, he didn't return to brokering stocks with his dad. This time, against the advice of both Graham and his father, he started an investing partnership of his own. He structured it in the image of what Graham had set up, and operated it mostly according to his principles. Graham and Buffett remained very close all the way through Graham's passing in 1976.

## Mr. Market

Graham's most valuable explanation of exactly how short-term market inefficiency works was crystallized in his concept of "Mr. Market." The idea is that a securities market can be thought of like a moody, manic-depressive fellow who stands ready to buy or sell you a half stake in his business every day. His behavior can be wild, and irrational, and is difficult to predict. Sometimes he's euphoric and thinks highly of his prospects. Here he'll offer to sell you

his stake only at the highest of prices. At other times he's depressed and doesn't think much of himself or his business. Here he offers to sell you the same stake in the same business at a much lower, bargain price. Oftentimes he's neutral. While you can never be sure what mood you will find him in, you can be sure that regardless of whether you trade with him today, Mr. Market will be back again with a new set of prices tomorrow.

Viewing the market through the lens of Graham's allegory reveals why the market price on any given day should not inform our view of a security's underlying intrinsic value. We must arrive at that figure independently and then only act when Mr. Market's mood is in our favor. That is what Buffett is driving home in his letters when he teaches, "a market quote's availability should never be turned into a liability whereby its periodic aberrations in turn formulate your judgments."<sup>6</sup> If you rely on the market's price to value a business, you're apt to miss opportunities to buy at times when he's depressed and sell when he's manic. You can't let the market do your thinking for you. Investors know they have to do their own work.

## When You Own a Stock You Own a Business

The "work," of course, is the appraisal of business value. While short-term prices may be at the mercy of Mr. Market's mood, over the long term a stock is going to approximately track the underlying intrinsic value of the business. Or as Graham put it: "In the short term, the market is like a voting machine, but in the long term, it's more like a weighing machine." This is true because a stock, by definition, is a fractional ownership claim on an entire company. If we can value the business, we can value the stock.

It's a mathematical certainty that a company's shares, in aggregate and over the entire span of the corporation's lifetime, must produce a return exactly in line with the results of the company's business. Yes, some shareholders will do better than others in the

interim depending on the timing of their purchases and sales, but in aggregate and in the end, the results of all the savvy or lucky outperformers will be matched dollar for dollar by an equal amount of underperformance from those who are naive or unlucky. Therefore, investors who through sound analysis are able to surmise the long-term future returns of a business will likely get those same long-term future returns through the ownership of its shares, as long as they are careful not to overpay.

That is why investors play for the long term. We learn through Buffett's teaching to focus our efforts on the business, not the short-term timing of when sound investments are likely to pay off. As Buffett wrote, "The course of the stock market will determine, to a great degree, when we will be right, but the accuracy of our analysis of the company will largely determine whether we will be right. In other words, we tend to concentrate on what should happen, not when it should happen."<sup>7</sup>

This idea is consistently stressed throughout the letters so I'll stress it again here: Stocks are not just pieces of paper to be traded back and forth, they are claims on a business, many of which can be analyzed and evaluated. If market prices of businesses (stocks) move below intrinsic values for any extended period of time, market forces will eventually act to correct the undervaluation because in the long term, the market is efficient.

"When" is not the relevant question because it's dependent on "Mr. Market," who is not reliable. It's hard to know at the time of purchase what's going to get him to wake up to the value you might see as being plainly there. However, companies often buy back their stock when they recognize it's cheap. Larger companies and private equity firms often look to acquire undervalued companies in their entirety. Market participants, aware of the potential for all of the above, often hunt for and buy such bargains, which in and of itself helps remove the discount. Buffett teaches investors to trust that the market will get it right eventually; he focuses us on finding the right businesses at the right prices, largely ignoring the timing of when to buy or when to expect the investment to work out.



## Market Guessing

Another lesson Buffett stresses is that the market's mood swings can be random, making them, *by definition*, often unpredictable. Trying to figure out what's going to happen in the short term is simply too hard and so his views on macro variables (general view on stocks, rates, FX, commodities, GDP) play no part in his investing decisions. Criticisms of those who use short-term predictions to make buy or sell decisions in stocks are peppered throughout the letters. He enjoys quoting Graham: "Speculation is neither illegal, immoral nor fattening (financially)."<sup>8</sup>

To this day, Buffett has remained true to this idea. There are just too many variables at play. Nonetheless, many Wall Street professionals continue to make these types of predictions. One need only turn on the television to see these market pundits, all seemingly following Lord Keynes's derisive advice: "If you can't forecast well, forecast often."

As investors, we understand that the right answer to questions about what stocks, bonds, interest rates, commodities, etc., are going to do over the next day, month, quarter, year, or even several years is "I don't have the first clue." Through Buffett's insights, we learn not to fall victim to the siren songs of these "expert" opinions and churn our portfolios, jumping from guesstimate to guesstimate and allowing what could otherwise be a decent result to be consumed by taxes, commissions, and random chance. According to Buffett, predictions often tell you more about the forecaster than they do about the future.

Some advice naturally follows: Give yourself permission to embrace the "I don't have the first clue" mode of thinking. It will free you from wasting valuable time and effort and allow you to focus on thinking from the vantage point of the owner or prospective owner of an entire business you might understand and come to find as attractive. Who would sell a farm because they thought there was at least a 65% chance the Fed was going to raise rates next year?

Also, be skeptical of anyone who claims to have a clear view into

the future. Here again we are reminded that you really can't out-source your thinking—you have to do it yourself. Your paid advisors, whether they do it willingly or not, will likely only steer you in the direction of doing what's good for *them*. It's just human nature. A good deal of Buffett's astonishing success during the Partnership years and beyond has come from never pretending to know things that were either unknowable or unknown. His teaching encourages other investors to embrace a similar agnostic attitude and to think for themselves.

## Predictable Pullbacks

**I**nclusive in the list of unknowables is when a big drop in the market is going to come. This is yet another key orienting principle that Buffett drew from Graham and Mr. Market. The market is inevitably going to slump into truly dour moods from time to time—very little can typically be done to avoid getting caught in the downdrafts. Buffett reminds investors that during such periods even a portfolio of extremely cheap stocks is likely to decline with the general market. He stresses this as an inevitable part of owning securities and that if a 50% decline in the value of your securities portfolio is going to cause you hardship, you need to reduce your exposure to the market.

The good news is that the occasional market drop is of little consequence to long-term investors. Preparing yourself to shrug off the next downturn is an important element of the method Buffett lays out. While no one knows what the market is going to do from year to year, odds are we will have at least a few 20–30% drops over the next decade or two. Exactly when these occur is of no great significance. What matters is where you start and where you end up—shuffle around the order of the plus and minus years and you still come to the same ultimate result in the end. Since the general trend is up, as long as a severe 25–40% drop isn't going to somehow