

**Note: The following table appears in the printed Annual Report on the facing page of the Chairman's Letter and is referred to in that letter.**

**Berkshire's Corporate Performance vs. the S&P 500**

Year	Annual Percentage Change		Relative Results (1)-(2)
	in Per-Share Book Value of Berkshire (1)	in S&P 500 with Dividends Included (2)	
1965	23.8	10.0	13.8
1966	20.3	(11.7)	32.0
1967	11.0	30.9	(19.9)
1968	19.0	11.0	8.0
1969	16.2	(8.4)	24.6
1970	12.0	3.9	8.1
1971	16.4	14.6	1.8
1972	21.7	18.9	2.8
1973	4.7	(14.8)	19.5
1974	5.5	(26.4)	31.9
1975	21.9	37.2	(15.3)
1976	59.3	23.6	35.7
1977	31.9	(7.4)	39.3
1978	24.0	6.4	17.6
1979	35.7	18.2	17.5
1980	19.3	32.3	(13.0)
1981	31.4	(5.0)	36.4
1982	40.0	21.4	18.6
1983	32.3	22.4	9.9
1984	13.6	6.1	7.5
1985	48.2	31.6	16.6
1986	26.1	18.6	7.5
1987	19.5	5.1	14.4
1988	20.1	16.6	3.5
1989	44.4	31.7	12.7
1990	7.4	(3.1)	10.5
1991	39.6	30.5	9.1
1992	20.3	7.6	12.7
1993	14.3	10.1	4.2
1994	13.9	1.3	12.6
1995	43.1	37.6	5.5
1996	31.8	23.0	8.8
1997	34.1	33.4	.7
1998	48.3	28.6	19.7
1999	.5	21.0	(20.5)
2000	6.5	(9.1)	15.6
2001	(6.2)	(11.9)	5.7
2002	10.0	(22.1)	32.1
2003	21.0	28.7	(7.7)
2004	10.5	10.9	(.4)
Average Annual Gain — 1965-2004	21.9	10.4	11.5
Overall Gain — 1964-2004	286,865	5,318	

Notes: Data are for calendar years with these exceptions: 1965 and 1966, year ended 9/30; 1967, 15 months ended 12/31.

Starting in 1979, accounting rules required insurance companies to value the equity securities they hold at market rather than at the lower of cost or market, which was previously the requirement. In this table, Berkshire's results through 1978 have been restated to conform to the changed rules. In all other respects, the results are calculated using the numbers originally reported.

The S&P 500 numbers are **pre-tax** whereas the Berkshire numbers are **after-tax**. If a corporation such as Berkshire were simply to have owned the S&P 500 and accrued the appropriate taxes, its results would have lagged the S&P 500 in years when that index showed a positive return, but would have exceeded the S&P in years when the index showed a negative return. Over the years, the tax costs would have caused the aggregate lag to be substantial.

## BERKSHIRE HATHAWAY INC.

### To the Shareholders of Berkshire Hathaway Inc.:

Our gain in net worth during 2004 was \$8.3 billion, which increased the per-share book value of both our Class A and Class B stock by 10.5%. Over the last 40 years (that is, since present management took over) book value has grown from \$19 to \$55,824, a rate of 21.9% compounded annually.\*

It's per-share intrinsic value that counts, however, not book value. Here, the news is good: Between 1964 and 2004, Berkshire morphed from a struggling northern textile business whose intrinsic value was less than book into a diversified enterprise worth far more than book. Our 40-year gain in intrinsic value has therefore somewhat exceeded our 21.9% gain in book. (For an explanation of intrinsic value and the economic principles that guide Charlie Munger, my partner and Berkshire's vice-chairman, and me in running Berkshire, please read our Owner's Manual, beginning on page 73.)

Despite their shortcomings, yearly calculations of book value are useful at Berkshire as a slightly understated gauge for measuring the *long-term* rate of increase in our intrinsic value. The calculations are less relevant, however, than they once were in rating any single year's performance versus the S&P 500 index (a comparison we display on the facing page). Our equity holdings (including convertible preferreds) have fallen considerably as a percentage of our net worth, from an average of 114% in the 1980s, for example, to less than 50% in recent years. Therefore, yearly movements in the stock market now affect a much smaller portion of our net worth than was once the case, a fact that will normally cause us to underperform in years when stocks rise substantially and overperform in years when they fall.

However the yearly comparisons work out, Berkshire's long-term performance versus the S&P remains all-important. Our shareholders can buy the S&P through an index fund at very low cost. Unless we achieve gains in per-share intrinsic value in the future that outdo the S&P, Charlie and I will be adding nothing to what you can accomplish on your own.

Last year, Berkshire's book-value gain of 10.5% fell short of the index's 10.9% return. Our lackluster performance was not due to any stumbles by the CEOs of our operating businesses: As always, they pulled more than their share of the load. My message to them is simple: Run your business as if it were the only asset your family will own over the next hundred years. Almost invariably they do just that and, after taking care of the needs of their business, send excess cash to Omaha for me to deploy.

I didn't do that job very well last year. My hope was to make several multi-billion dollar acquisitions that would add new and significant streams of earnings to the many we already have. But I struck out. Additionally, I found very few attractive securities to buy. Berkshire therefore ended the year with \$43 billion of cash equivalents, not a happy position. Charlie and I will work to translate some of this hoard into more interesting assets during 2005, though we can't promise success.

In one respect, 2004 was a remarkable year for the stock market, a fact buried in the maze of numbers on page 2. If you examine the 35 years since the 1960s ended, you will find that an investor's return, including dividends, from owning the S&P has averaged 11.2% annually (well above what we expect future returns to be). But if you look for years with returns anywhere close to that 11.2% – say, between 8% and 14% – you will find only *one* before 2004. In other words, last year's "normal" return is anything but.

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\*All figures used in this report apply to Berkshire's A shares, the successor to the only stock that the company had outstanding before 1996. The B shares have an economic interest equal to 1/30<sup>th</sup> that of the A.

Over the 35 years, American business has delivered terrific results. It should therefore have been easy for investors to earn juicy returns: All they had to do was piggyback Corporate America in a diversified, low-expense way. An index fund that they never touched would have done the job. Instead many investors have had experiences ranging from mediocre to disastrous.

There have been three primary causes: first, high costs, usually because investors traded excessively or spent far too much on investment management; second, portfolio decisions based on tips and fads rather than on thoughtful, quantified evaluation of businesses; and third, a start-and-stop approach to the market marked by untimely entries (after an advance has been long underway) and exits (after periods of stagnation or decline). Investors should remember that excitement and expenses are their enemies. And if they insist on trying to time their participation in equities, they should try to be fearful when others are greedy and greedy only when others are fearful.

### **Sector Results**

As managers, Charlie and I want to give our owners the financial information and commentary we would wish to receive if our roles were reversed. To do this with both clarity and reasonable brevity becomes more difficult as Berkshire's scope widens. Some of our businesses have vastly different economic characteristics from others, which means that our consolidated statements, with their jumble of figures, make useful analysis almost impossible.

On the following pages, therefore, we will present some balance sheet and earnings figures from our four major categories of businesses along with commentary about each. We particularly want you to understand the limited circumstances under which we will use debt, given that we typically shun it. We will not, however, inundate you with data that has no real value in estimating Berkshire's intrinsic value. Doing so would tend to obfuscate the facts that count.

### **Regulated Utility Businesses**

We have an 80.5% (fully diluted) interest in MidAmerican Energy Holdings, which owns a wide variety of utility operations. The largest of these are (1) Yorkshire Electricity and Northern Electric, whose 3.7 million electric customers make it the third largest distributor of electricity in the U.K.; (2) MidAmerican Energy, which serves 698,000 electric customers, primarily in Iowa; and (3) Kern River and Northern Natural pipelines, which carry 7.9% of the natural gas consumed in the U.S.

The remaining 19.5% of MidAmerican is owned by three partners of ours: Dave Sokol and Greg Abel, the brilliant managers of these businesses, and Walter Scott, a long-time friend of mine who introduced me to the company. Because MidAmerican is subject to the Public Utility Holding Company Act ("PUHCA"), Berkshire's voting interest is limited to 9.9%. Voting control rests with Walter.

Our limited voting interest forces us to account for MidAmerican in an abbreviated manner. Instead of our fully incorporating the company's assets, liabilities, revenues and expenses into Berkshire's statements, we make one-line entries only in both our balance sheet and income account. It's likely, though, that PUHCA will someday – perhaps soon – be repealed or that accounting rules will change. Berkshire's consolidated figures would then incorporate all of MidAmerican, including the substantial debt it utilizes (though this debt is not now, nor will it ever be, an obligation of Berkshire).

At yearend, \$1.478 billion of MidAmerican's junior debt was payable to Berkshire. This debt has allowed acquisitions to be financed without our partners needing to increase their already substantial investments in MidAmerican. By charging 11% interest, Berkshire is compensated fairly for putting up the funds needed for purchases, while our partners are spared dilution of their equity interests. Because MidAmerican made no large acquisitions last year, it paid down \$100 million of what it owes us.

MidAmerican also owns a significant non-utility business, HomeServices of America, the second largest real estate broker in the country. Unlike our utility operations, this business is highly cyclical, but nevertheless one we view enthusiastically. We have an exceptional manager, Ron Peltier, who through both his acquisition and operational skills is building a brokerage powerhouse.

HomeServices participated in \$59.8 billion of transactions in 2004, a gain of \$11.2 billion from 2003. About 24% of the increase came from six acquisitions made during the year. Through our 17 brokerage firms – all of which retain their local identities – we employ more than 18,000 brokers in 18 states. HomeServices is almost certain to grow substantially in the next decade as we continue to acquire leading localized operations.

Last year MidAmerican wrote off a major investment in a zinc recovery project that was initiated in 1998 and became operational in 2002. Large quantities of zinc are present in the brine produced by our California geothermal operations, and we believed we could profitably extract the metal. For many months, it appeared that commercially-viable recoveries were imminent. But in mining, just as in oil exploration, prospects have a way of “teasing” their developers, and every time one problem was solved, another popped up. In September, we threw in the towel.

Our failure here illustrates the importance of a guideline – *stay with simple propositions* – that we usually apply in investments as well as operations. If only one variable is key to a decision, and the variable has a 90% chance of going your way, the chance for a successful outcome is obviously 90%. But if ten independent variables need to break favorably for a successful result, and each has a 90% probability of success, the likelihood of having a winner is only 35%. In our zinc venture, we solved most of the problems. But one proved intractable, and that was one too many. Since a chain is no stronger than its weakest link, it makes sense to look for – if you’ll excuse an oxymoron – mono-linked chains.

A breakdown of MidAmerican’s results follows. In 2004, the “other” category includes a \$72.2 million profit from sale of an Enron receivable that was thrown in when we purchased Northern Natural two years earlier. Walter, Dave and I, as natives of Omaha, view this unanticipated gain as war reparations – partial compensation for the loss our city suffered in 1986 when Ken Lay moved Northern to Houston, after promising to leave the company here. (For details, see Berkshire’s 2002 annual report.)

Here are some key figures on MidAmerican’s operations:

	<i>Earnings (in \$ millions)</i>	
	<u>2004</u>	<u>2003</u>
U.K. utilities .....	\$ 326	\$ 289
Iowa utility .....	268	269
Pipelines .....	288	261
HomeServices.....	130	113
Other (net) .....	172	190
Loss from zinc project.....	<u>(579)</u>	<u>(46)</u>
Earnings before corporate interest and taxes .....	605	1,076
Interest, other than to Berkshire .....	(212)	(225)
Interest on Berkshire junior debt .....	(170)	(184)
Income tax .....	<u>(53)</u>	<u>(251)</u>
Net earnings.....	<u>\$ 170</u>	<u>\$ 416</u>
Earnings applicable to Berkshire* .....	\$ 237	\$ 429
Debt owed to others.....	10,528	10,296
Debt owed to Berkshire .....	1,478	1,578

\*Includes interest earned by Berkshire (net of related income taxes) of \$110 in 2004 and \$118 in 2003.

## Insurance

Since Berkshire purchased National Indemnity (“NICO”) in 1967, property-casualty insurance has been our core business and the propellant of our growth. Insurance has provided a fountain of funds with which we’ve acquired the securities and businesses that now give us an ever-widening variety of earnings streams. So in this section, I will be spending a little time telling you how we got where we are.

The source of our insurance funds is “float,” which is money that doesn’t belong to us but that we temporarily hold. Most of our float arises because (1) premiums are paid upfront though the service we provide – insurance protection – is delivered over a period that usually covers a year and; (2) loss events that occur today do not always result in our immediately paying claims, because it sometimes takes many years for losses to be reported (asbestos losses would be an example), negotiated and settled. The \$20 million of float that came with our 1967 purchase has now increased – both by way of internal growth and acquisitions – to \$46.1 billion.

Float is wonderful – *if* it doesn’t come at a high price. Its cost is determined by underwriting results, meaning how the expenses and losses we will ultimately pay compare with the premiums we have received. When an underwriting profit is achieved – as has been the case at Berkshire in about half of the 38 years we have been in the insurance business – float is better than free. In such years, we are actually paid for holding other people’s money. For most insurers, however, life has been far more difficult: In aggregate, the property-casualty industry almost invariably operates at an underwriting loss. When that loss is large, float becomes expensive, sometimes devastatingly so.

Insurers have generally earned poor returns for a simple reason: They sell a commodity-like product. Policy forms are standard, and the product is available from many suppliers, some of whom are mutual companies (“owned” by policyholders rather than stockholders) with profit goals that are limited. Moreover, most insureds don’t care from whom they buy. Customers by the millions say “I need some Gillette blades” or “I’ll have a Coke” but we wait in vain for “I’d like a National Indemnity policy, please.” Consequently, price competition in insurance is usually fierce. Think airline seats.

So, you may ask, how do Berkshire’s insurance operations overcome the dismal economics of the industry and achieve some measure of enduring competitive advantage? We’ve attacked that problem in several ways. Let’s look first at NICO’s strategy.

When we purchased the company – a specialist in commercial auto and general liability insurance – it did not appear to have any attributes that would overcome the industry’s chronic troubles. It was not well-known, had no informational advantage (the company has never had an actuary), was not a low-cost operator, and sold through general agents, a method many people thought outdated. Nevertheless, for almost all of the past 38 years, NICO has been a star performer. Indeed, had we not made this acquisition, Berkshire would be lucky to be worth half of what it is today.

What we’ve had going for us is a managerial mindset that most insurers find impossible to replicate. Take a look at the facing page. Can you imagine *any* public company embracing a business model that would lead to the decline in revenue that we experienced from 1986 through 1999? That colossal slide, it should be emphasized, did not occur because business was unobtainable. Many billions of premium dollars were readily available to NICO had we only been willing to cut prices. But we instead consistently priced to make a profit, not to match our most optimistic competitor. We never left customers – but they left us.

Most American businesses harbor an “institutional imperative” that rejects extended decreases in volume. What CEO wants to report to his shareholders that not only did business contract last year but that it will continue to drop? In insurance, the urge to keep writing business is also intensified because the consequences of foolishly-priced policies may not become apparent for some time. If an insurer is optimistic in its reserving, reported earnings will be overstated, and years may pass before true loss costs are revealed (a form of self-deception that nearly destroyed GEICO in the early 1970s).

Portrait of a Disciplined Underwriter  
National Indemnity Company

<u>Year</u>	<u>Written Premium (In \$ millions)</u>	<u>No. of Employees at Year-End</u>	<u>Ratio of Operating Expenses to Written Premium</u>	<u>Underwriting Profit (Loss) as a Per- centage of Premiums (Calculated as of year end 2004)*</u>
1980	\$79.6	372	32.3%	8.2%
1981	59.9	353	36.1%	(.8%)
1982	52.5	323	36.7%	(15.3%)
1983	58.2	308	35.6%	(18.7%)
1984	62.2	342	35.5%	(17.0%)
1985	160.7	380	28.0%	1.9%
1986	366.2	403	25.9%	30.7%
1987	232.3	368	29.5%	27.3%
1988	139.9	347	31.7%	24.8%
1989	98.4	320	35.9%	14.8%
1990	87.8	289	37.4%	7.0%
1991	88.3	284	35.7%	13.0%
1992	82.7	277	37.9%	5.2%
1993	86.8	279	36.1%	11.3%
1994	85.9	263	34.6%	4.6%
1995	78.0	258	36.6%	9.2%
1996	74.0	243	36.5%	6.8%
1997	65.3	240	40.4%	6.2%
1998	56.8	231	40.4%	9.4%
1999	54.5	222	41.2%	4.5%
2000	68.1	230	38.4%	2.9%
2001	161.3	254	28.8%	(11.6%)
2002	343.5	313	24.0%	16.8%
2003	594.5	337	22.2%	18.1%
2004	605.6	340	22.5%	5.1%

\*It takes a long time to learn the true profitability of any given year. First, many claims are received after the end of the year, and we must estimate how many of these there will be and what they will cost. (In insurance jargon, these claims are termed IBNR – incurred but not reported.) Second, claims often take years, or even decades, to settle, which means there can be many surprises along the way.

For these reasons, the results in this column simply represent our best estimate at the end of 2004 as to how we have done in prior years. Profit margins for the years through 1999 are probably close to correct because these years are “mature,” in the sense that they have few claims still outstanding. The more recent the year, the more guesswork is involved. In particular, the results shown for 2003 and 2004 are apt to change significantly.

Finally, there is a fear factor at work, in that a shrinking business usually leads to layoffs. To avoid pink slips, employees will rationalize inadequate pricing, telling themselves that poorly-priced business must be tolerated in order to keep the organization intact and the distribution system happy. If this course isn't followed, these employees will argue, the company will not participate in the recovery that they invariably feel is just around the corner.

To combat employees' natural tendency to save their own skins, we have always promised NICO's workforce that *no one* will be fired because of declining volume, however severe the contraction. (This is not Donald Trump's sort of place.) NICO is not labor-intensive, and, as the table suggests, can live with excess overhead. It can't live, however, with underpriced business and the breakdown in underwriting discipline that accompanies it. An insurance organization that doesn't care deeply about underwriting at a profit *this* year is unlikely to care *next* year either.

Naturally, a business that follows a no-layoff policy must be especially careful to avoid overstaffing when times are good. Thirty years ago Tom Murphy, then CEO of Cap Cities, drove this point home to me with a hypothetical tale about an employee who asked his boss for permission to hire an assistant. The employee assumed that adding \$20,000 to the annual payroll would be inconsequential. But his boss told him the proposal should be evaluated as a \$3 million decision, given that an additional person would probably cost at least that amount over his lifetime, factoring in raises, benefits and other expenses (more people, more toilet paper). And unless the company fell on very hard times, the employee added would be unlikely to be dismissed, however marginal his contribution to the business.

It takes real fortitude – embedded deep within a company's culture – to operate as NICO does. Anyone examining the table can scan the years from 1986 to 1999 quickly. But living day after day with dwindling volume – while competitors are boasting of growth and reaping Wall Street's applause – is an experience few managers can tolerate. NICO, however, has had four CEOs since its formation in 1940 and *none* have bent. (It should be noted that only one of the four graduated from college. Our experience tells us that extraordinary business ability is largely innate.)

The current managerial star – make that superstar – at NICO is Don Wurster (yes, he's "the graduate"), who has been running things since 1989. His slugging percentage is right up there with Barry Bonds' because, like Barry, Don will accept a walk rather than swing at a bad pitch. Don has now amassed \$950 million of float at NICO that over time is almost certain to be proved the negative-cost kind. Because insurance prices are falling, Don's volume will soon decline very significantly and, as it does, Charlie and I will applaud him ever more loudly.

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Another way to prosper in a commodity-type business is to be the low-cost operator. Among auto insurers operating on a broad scale, GEICO holds that cherished title. For NICO, as we have seen, an ebb-and-flow business model makes sense. But a company holding a low-cost advantage must pursue an unrelenting foot-to-the-floor strategy. And that's just what we do at GEICO.

A century ago, when autos first appeared, the property-casualty industry operated as a cartel. The major companies, most of which were based in the Northeast, established "bureau" rates and that was it. No one cut prices to attract business. Instead, insurers competed for strong, well-regarded agents, a focus that produced high commissions for agents and high prices for consumers.

In 1922, State Farm was formed by George Mecherle, a farmer from Merna, Illinois, who aimed to take advantage of the pricing umbrella maintained by the high-cost giants of the industry. State Farm employed a "captive" agency force, a system keeping its acquisition costs lower than those incurred by the bureau insurers (whose "independent" agents successfully played off one company against another). With its low-cost structure, State Farm eventually captured about 25% of the personal lines (auto and homeowners) business, far outdistancing its once-mighty competitors. Allstate, formed in 1931, put a similar distribution system into place and soon became the runner-up in personal lines to State Farm. Capitalism had worked its magic, and these low-cost operations looked unstoppable.

But a man named Leo Goodwin had an idea for an even more efficient auto insurer and, with a skimpy \$200,000, started GEICO in 1936. Goodwin's plan was to eliminate the agent entirely and to deal instead directly with the auto owner. Why, he asked himself, should there be any unnecessary and expensive links in the distribution mechanism when the product, auto insurance, was both mandatory and costly. Purchasers of business insurance, he reasoned, might well require professional advice, but most consumers knew what they needed in an auto policy. That was a powerful insight.

Originally, GEICO mailed its low-cost message to a limited audience of government employees. Later, it widened its horizons and shifted its marketing emphasis to the phone, working inquiries that came from broadcast and print advertising. And today the Internet is coming on strong.

Between 1936 and 1975, GEICO grew from a standing start to a 4% market share, becoming the country's fourth largest auto insurer. During most of this period, the company was superbly managed, achieving both excellent volume gains and high profits. It looked unstoppable. But after my friend and hero Lorimer Davidson retired as CEO in 1970, his successors soon made a huge mistake by under-reserving for losses. This produced faulty cost information, which in turn produced inadequate pricing. By 1976, GEICO was on the brink of failure.

Jack Byrne then joined GEICO as CEO and, almost single-handedly, saved the company by heroic efforts that included major price increases. Though GEICO's survival required these, policyholders fled the company, and by 1980 its market share had fallen to 1.8%. Subsequently, the company embarked on some unwise diversification moves. This shift of emphasis away from its extraordinary core business stunted GEICO's growth, and by 1993 its market share had grown only fractionally, to 1.9%. Then Tony Nicely took charge.

And what a difference that's made: In 2005 GEICO will probably secure a 6% market share. Better yet, Tony has matched growth with profitability. Indeed, GEICO delivers all of its constituents major benefits: In 2004 its customers saved \$1 billion or so compared to what they would otherwise have paid for coverage, its associates earned a \$191 million profit-sharing bonus that averaged 24.3% of salary, and its owner – that's us – enjoyed excellent financial returns.

There's more good news. When Jack Byrne was rescuing the company in 1976, New Jersey refused to grant him the rates he needed to operate profitably. He therefore promptly – and properly – withdrew from the state. Subsequently, GEICO avoided both New Jersey and Massachusetts, recognizing them as two jurisdictions in which insurers were destined to struggle.

In 2003, however, New Jersey took a new look at its chronic auto-insurance problems and enacted legislation that would curb fraud and allow insurers a fair playing field. Even so, one might have expected the state's bureaucracy to make change slow and difficult.

But just the opposite occurred. Holly Bakke, the New Jersey insurance commissioner, who would be a success in *any* line of work, was determined to turn the law's intent into reality. With her staff's cooperation, GEICO ironed out the details for re-entering the state and was licensed last August. Since then, we've received a response from New Jersey drivers that is multiples of my expectations.

We are now serving 140,000 policyholders – about 4% of the New Jersey market – and saving them substantial sums (as we do drivers everywhere). Word-of-mouth recommendations within the state are causing inquiries to pour in. And once we hear from a New Jersey prospect, our closure rate – the percentage of policies issued to inquiries received – is far higher in the state than it is nationally.

We make no claim, of course, that we can save *everyone* money. Some companies, using rating systems that are different from ours, will offer certain classes of drivers a lower rate than we do. But we believe GEICO offers the lowest price more often than any other national company that serves all segments of the public. In addition, in most states, including New Jersey, Berkshire shareholders receive an 8% discount. So gamble fifteen minutes of your time and go to GEICO.com – or call 800-847-7536 – to see



whether you can save big money (which you might want to use, of course, to buy other Berkshire products).

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Reinsurance – insurance sold to other insurers who wish to lay off part of the risks they have assumed – should *not* be a commodity product. At bottom, any insurance policy is simply a promise, and as everyone knows, promises vary enormously in their quality.

At the primary insurance level, nevertheless, just who makes the promise is often of minor importance. In personal-lines insurance, for example, states levy assessments on solvent companies to pay the policyholders of companies that go broke. In the business-insurance field, the same arrangement applies to workers’ compensation policies. “Protected” policies of these types account for about 60% of the property-casualty industry’s volume. Prudently-run insurers are irritated by the need to subsidize poor or reckless management elsewhere, but that’s the way it is.

Other forms of business insurance at the primary level involve promises that carry greater risks for the insured. When Reliance Insurance and Home Insurance were run into the ground, for example, their promises proved to be worthless. Consequently, many holders of their business policies (other than those covering workers’ compensation) suffered painful losses.

The solvency risk in primary policies, however, pales in comparison to that lurking in reinsurance policies. When a reinsurer goes broke, staggering losses almost always strike the primary companies it has dealt with. This risk is far from minor: GEICO has suffered tens of millions in losses from its careless selection of reinsurers in the early 1980s.

Were a true mega-catastrophe to occur in the next decade or two – and that’s a real possibility – some reinsurers would not survive. The largest insured loss to date is the World Trade Center disaster, which cost the insurance industry an estimated \$35 billion. Hurricane Andrew cost insurers about \$15.5 billion in 1992 (though that loss would be far higher in today’s dollars). Both events rocked the insurance and reinsurance world. But a \$100 billion event, or even a larger catastrophe, remains a possibility if either a particularly severe earthquake or hurricane hits just the wrong place. Four significant hurricanes struck Florida during 2004, causing an aggregate of \$25 billion or so in insured losses. Two of these – Charley and Ivan – could have done at least three times the damage they did had they entered the U.S. not far from their actual landing points.

Many insurers regard a \$100 billion industry loss as “unthinkable” and won’t even plan for it. But at Berkshire, we are fully prepared. Our share of the loss would probably be 3% to 5%, and earnings from our investments and other businesses would comfortably exceed that cost. When “the day after” arrives, Berkshire’s checks will clear.

Though the hurricanes hit us with a \$1.25 billion loss, our reinsurance operations did well last year. At General Re, Joe Brandon has restored a long-admired culture of underwriting discipline that, for a time, had lost its way. The excellent results he realized in 2004 on current business, however, were offset by adverse developments from the years before he took the helm. At NICO’s reinsurance operation, Ajit Jain continues to successfully underwrite huge risks that no other reinsurer is willing or able to accept. Ajit’s value to Berkshire is enormous.

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Our insurance managers, maximizing the competitive strengths I’ve mentioned in this section, again delivered first-class underwriting results last year. As a consequence, our float was better than costless. Here’s the scorecard:

(in \$ millions)

<u>Insurance Operations</u>	<u>Underwriting Profit</u>		<u>Yearend Float</u>	
	<u>2004</u>	<u>2004</u>	<u>2004</u>	<u>2003</u>
General Re .....	\$ 3	\$23,120	\$23,654	
B-H Reinsurance .....	417	15,278	13,948	
GEICO .....	970	5,960	5,287	
Other Primary* .....	161	1,736	1,331	
Total .....	<u>\$1,551</u>	<u>\$46,094</u>	<u>\$44,220</u>	

\*Includes, in addition to National Indemnity, a variety of other exceptional insurance businesses, run by Rod Eldred, John Kizer, Tom Nerney and Don Towle.

Berkshire's float increased \$1.9 billion in 2004, even though a few insureds opted to commute (that is, unwind) certain reinsurance contracts. We agree to such commutations only when we believe the economics are favorable to us (after giving due weight to what we might earn in the future on the money we are returning).

To summarize, last year we were paid more than \$1.5 billion to hold an average of about \$45.2 billion. In 2005 pricing will be less attractive than it has been. Nevertheless, absent a mega-catastrophe, we have a decent chance of achieving no-cost float again this year.

### **Finance and Finance Products**

Last year in this section we discussed a potpourri of activities. In this report, we'll skip over several that are now of lesser importance: Berkadia is down to tag ends; Value Capital has added other investors, negating our expectation that we would need to consolidate its financials into ours; and the trading operation that I run continues to shrink.

- Both of Berkshire's leasing operations rebounded last year. At CORT (office furniture), earnings remain inadequate, but are trending upward. XTRA disposed of its container and intermodal businesses in order to concentrate on trailer leasing, long its strong suit. Overhead has been reduced, asset utilization is up and decent profits are now being achieved under Bill Franz, the company's new CEO.
- The wind-down of Gen Re Securities continues. We decided to exit this derivative operation three years ago, but getting out is easier said than done. Though derivative instruments are purported to be highly liquid – and though we have had the benefit of a benign market while liquidating ours – we still had 2,890 contracts outstanding at yearend, down from 23,218 at the peak. Like Hell, derivative trading is easy to enter but difficult to leave. (Other similarities come to mind as well.)

Gen Re's derivative contracts have always been required to be marked to market, and I believe the company's management conscientiously tried to make realistic "marks." The market prices of derivatives, however, can be very fuzzy in a world in which settlement of a transaction is sometimes decades away and often involves multiple variables as well. In the interim the marks influence the managerial and trading bonuses that are paid annually. It's small wonder that phantom profits are often recorded.

Investors should understand that in all types of financial institutions, rapid growth sometimes masks major underlying problems (and occasionally fraud). The real test of the earning power of a derivatives operation is what it achieves after operating for an extended period in a no-growth mode. You only learn who has been swimming naked when the tide goes out.

- After 40 years, we've finally generated a little synergy at Berkshire: Clayton Homes is doing well and that's in part due to its association with Berkshire. The manufactured home industry

continues to reside in the intensive care unit of Corporate America, having sold less than 135,000 new homes last year, about the same as in 2003. Volume in these years was the lowest since 1962, and it was also only about 40% of annual sales during the years 1995-99. That era, characterized by irresponsible financing and naïve funders, was a fool's paradise for the industry.

Because one major lender after another has fled the field, financing continues to bedevil manufacturers, retailers and purchasers of manufactured homes. Here Berkshire's support has proven valuable to Clayton. We stand ready to fund whatever makes sense, and last year Clayton's management found much that qualified.

As we explained in our 2003 report, we believe in using borrowed money to support profitable, interest-bearing receivables. At the beginning of last year, we had borrowed \$2 billion to relend to Clayton (at a one percentage-point markup) and by January 2005 the total was \$7.35 billion. Most of the dollars added were borrowed by us on January 4, 2005, to finance a seasoned portfolio that Clayton purchased on December 30, 2004 from a bank exiting the business.

We now have two additional portfolio purchases in the works, totaling about \$1.6 billion, but it's quite unlikely that we will secure others of any significance. Therefore, Clayton's receivables (in which originations will roughly offset payoffs) will probably hover around \$9 billion for some time and should deliver steady earnings. This pattern will be far different from that of the past, in which Clayton, like all major players in its industry, "securitized" its receivables, causing earnings to be front-ended. In the last two years, the securitization market has dried up. The limited funds available today come only at higher cost and with harsh terms. Had Clayton remained independent in this period, it would have had mediocre earnings as it struggled with financing.

In April, Clayton completed the acquisition of Oakwood Homes and is now the industry's largest producer and retailer of manufactured homes. We love putting more assets in the hands of Kevin Clayton, the company's CEO. He is a prototype Berkshire manager. Today, Clayton has 11,837 employees, up from 7,136 when we purchased it, and Charlie and I are pleased that Berkshire has been useful in facilitating this growth.

For simplicity's sake, we include all of Clayton's earnings in this sector, though a sizable portion of these are derived from areas other than consumer finance.

	<i>(in \$ millions)</i>			
	<u>Pre-Tax Earnings</u>		<u>Interest-Bearing Liabilities</u>	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Trading – ordinary income .....	\$ 264	\$ 355	\$5,751	\$7,826
Gen Re Securities .....	(44)	(99)	5,437*	8,041*
Life and annuity operation.....	(57)	85	2,467	2,331
Value Capital .....	30	31	N/A	N/A
Berkadia .....	1	101	—	525
Leasing operations.....	92	34	391	482
Manufactured housing finance (Clayton) .....	220	37**	3,636	2,032
Other.....	<u>78</u>	<u>75</u>	N/A	N/A
Income before capital gains.....	584	619		
Trading – capital gains .....	<u>1,750</u>	<u>1,215</u>		
Total .....	<u>\$2,334</u>	<u>\$1,834</u>		

\* Includes all liabilities

\*\* From date of acquisition, August 7, 2003

## Manufacturing, Service and Retailing Operations

Our activities in this category cover the waterfront. But let's look at a summary balance sheet and earnings statement consolidating the entire group.

### Balance Sheet 12/31/04 (in \$ millions)

<u>Assets</u>		<u>Liabilities and Equity</u>	
Cash and equivalents .....	\$ 899	Notes payable .....	\$ 1,143
Accounts and notes receivable .....	3,074	Other current liabilities .....	<u>4,685</u>
Inventory .....	3,842	Total current liabilities .....	5,828
Other current assets .....	<u>254</u>		
Total current assets .....	8,069		
Goodwill and other intangibles.....	8,362	Deferred taxes.....	248
Fixed assets.....	6,161	Term debt and other liabilities.....	1,965
Other assets.....	<u>1,044</u>	Equity .....	<u>15,595</u>
	<u>\$23,636</u>		<u>\$23,636</u>

### Earnings Statement (in \$ millions)

	<u>2004</u>	<u>2003</u>
Revenues .....	\$44,142	\$32,106
Operating expenses (including depreciation of \$676 in 2004 and \$605 in 2003).....	41,604	29,885
Interest expense (net).....	<u>57</u>	<u>64</u>
Pre-tax earnings.....	2,481	2,157
Income taxes.....	<u>941</u>	<u>813</u>
Net income .....	<u>\$ 1,540</u>	<u>\$ 1,344</u>

This eclectic group, which sells products ranging from Dilly Bars to fractional interests in Boeing 737s, earned a very respectable 21.7% on average tangible net worth last year, compared to 20.7% in 2003. It's noteworthy that these operations used only minor financial leverage in achieving these returns. Clearly, we own some very good businesses. We purchased many of them, however, at substantial premiums to net worth – a matter that is reflected in the goodwill item shown on the balance sheet – and that fact reduces the earnings on our average *carrying* value to 9.9%.

Here are the pre-tax earnings for the larger categories or units.

	<u>Pre-Tax Earnings</u> <u>(in \$ millions)</u>	
	<u>2004</u>	<u>2003</u>
Building Products .....	\$ 643	\$ 559
Shaw Industries .....	466	436
Apparel & Footwear .....	325	289
Retailing of Jewelry, Home Furnishings and Candy .....	215	224
Flight Services.....	191	72
McLane.....	228	150*
Other businesses .....	<u>413</u>	<u>427</u>
	<u>\$2,481</u>	<u>\$2,157</u>

\* From date of acquisition, May 23, 2003.

- In the building-products sector and at Shaw, we've experienced staggering cost increases for both raw-materials and energy. By December, for example, steel costs at MiTek (whose primary business is connectors for roof trusses) were running 100% over a year earlier. And MiTek uses 665 million pounds of steel every year. Nevertheless, the company continues to be an outstanding performer.

Since we purchased MiTek in 2001, Gene Toombs, its CEO, has made some brilliant “bolt-on” acquisitions and is on his way to creating a mini-Berkshire.

Shaw fielded a barrage of price increases in its main fiber materials during the year, a hit that added more than \$300 million to its costs. (When you walk on carpet you are, in effect, stepping on processed oil.) Though we followed these hikes in costs with price increases of our own, there was an inevitable lag. Therefore, margins narrowed as the year progressed and remain under pressure today. Despite these roadblocks, Shaw, led by Bob Shaw and Julian Saul, earned an outstanding 25.6% on tangible equity in 2004. The company is a powerhouse and has a bright future.

- In apparel, Fruit of the Loom increased unit sales by 10 million dozen, or 14%, with shipments of intimate apparel for women and girls growing by 31%. Charlie, who is far more knowledgeable than I am on this subject, assures me that women are *not* wearing more underwear. With this expert input, I can only conclude that our market share in the women’s category must be growing rapidly. Thanks to John Holland, Fruit is on the move.

A smaller operation, Garan, also had an excellent year. Led by Seymour Lichtenstein and Jerry Kamiel, this company manufactures the popular Garanimals line for children. Next time you are in a Wal-Mart, check out this imaginative product.

- Among our retailers, Ben Bridge (jewelry) and R. C. Willey (home furnishings) were particular standouts last year.

At Ben Bridge same-store sales grew 11.4%, the best gain among the publicly-held jewelers whose reports I have seen. Additionally, the company’s profit margin widened. Last year was not a fluke: During the past decade, the same-store sales gains of the company have averaged 8.8%.

Ed and Jon Bridge are fourth-generation managers and run the business exactly as if it were their own – which it is in every respect except for Berkshire’s name on the stock certificates. The Bridges have expanded successfully by securing the right locations and, more importantly, by staffing these stores with enthusiastic and knowledgeable associates. We will move into Minneapolis-St. Paul this year.

At Utah-based R. C. Willey, the gains from expansion have been even more dramatic, with 41.9% of 2004 sales coming from out-of-state stores that didn’t exist before 1999. The company also improved its profit margin in 2004, propelled by its two new stores in Las Vegas.

I would like to tell you that these stores were my idea. In truth, I thought they were mistakes. I knew, of course, how brilliantly Bill Child had run the R. C. Willey operation in Utah, where its market share had long been huge. But I felt our closed-on-Sunday policy would prove disastrous away from home. Even our first out-of-state store in Boise, which was highly successful, left me unconvinced. I kept asking whether Las Vegas residents, conditioned to seven-day-a-week retailers, would adjust to us. Our first Las Vegas store, opened in 2001, answered this question in a resounding manner, immediately becoming our number one unit.

Bill and Scott Hymas, his successor as CEO, then proposed a second Las Vegas store, only about 20 minutes away. I felt this expansion would cannibalize the first unit, adding significant costs but only modest sales. The result? Each store is now doing about 26% more volume than any other store in the chain and is consistently showing large year-over-year gains.

R. C. Willey will soon open in Reno. Before making this commitment, Bill and Scott again asked for my advice. Initially, I was pretty puffed up about the fact that they were consulting me. But then it dawned on me that the opinion of someone who is *always* wrong has its own special utility to decision-makers.

- Earnings improved in flight services. At FlightSafety, the world's leader in pilot training, profits rose as corporate aviation rebounded and our business with regional airlines increased. We now operate 283 simulators with an original cost of \$1.2 billion. Pilots are trained one at a time on this expensive equipment. This means that as much as \$3.50 of capital investment is required to produce \$1 of annual revenue. With this level of capital intensity, FlightSafety requires very high operating margins in order to obtain reasonable returns on capital, which means that utilization rates are all-important. Last year, FlightSafety's return on tangible equity improved to 15.1% from 8.4% in 2003.

In another 2004 event, Al Ueltschi, who founded FlightSafety in 1951 with \$10,000, turned over the CEO position to Bruce Whitman, a 43-year veteran at the company. (But Al's not going anywhere; I won't let him.) Bruce shares Al's conviction that flying an aircraft is a privilege to be extended only to people who regularly receive the highest quality of training and are undeniably competent. A few years ago, Charlie was asked to intervene with Al on behalf of a tycoon friend whom FlightSafety had flunked. Al's reply to Charlie: "Tell your pal he belongs in the back of the plane, not the cockpit."

FlightSafety's number one customer is NetJets, our aircraft fractional-ownership subsidiary. Its 2,100 pilots spend an average of 18 days a year in training. Additionally, these pilots fly only one aircraft type whereas many flight operations juggle pilots among several types. NetJets' high standards on both fronts are two of the reasons I signed up with the company years before Berkshire bought it.

Fully as important in my decisions to both use and buy NetJets, however, was the fact that the company was managed by Rich Santulli, the creator of the fractional-ownership industry and a fanatic about safety and service. I viewed the selection of a flight provider as akin to picking a brain surgeon: you simply want the best. (Let someone else experiment with the low bidder.)

Last year NetJets again gained about 70% of the net new business (measured by dollar value) going to the four companies that dominate the industry. A portion of our growth came from the 25-hour card offered by Marquis Jet Partners. Marquis is not owned by NetJets, but is instead a customer that repackages the purchases it makes from us into smaller packages that it sells through its card. Marquis deals exclusively with NetJets, utilizing the power of our reputation in its marketing.

Our U.S. contracts, including Marquis customers, grew from 3,877 to 4,967 in 2004 (versus approximately 1,200 contracts when Berkshire bought NetJets in 1998). Some clients (including me) enter into multiple contracts because they wish to use more than one type of aircraft, selecting for any given trip whichever type best fits the mission at hand.

NetJets earned a modest amount in the U.S. last year. But what we earned domestically was largely offset by losses in Europe. We are now, however, generating real momentum abroad. Contracts (including 25-hour cards that we ourselves market in Europe) increased from 364 to 693 during the year. We will again have a very significant European loss in 2005, but domestic earnings will likely put us in the black overall.

Europe has been expensive for NetJets – far more expensive than I anticipated – but it is essential to building a flight operation that will forever be in a class by itself. Our U.S. owners already want a quality service wherever they travel and their wish for flight hours abroad is certain to grow dramatically in the decades ahead. Last year, U.S. owners made 2,003 flights in Europe, up 22% from the previous year and 137% from 2000. Just as important, our European owners made 1,067 flights in the U.S., up 65% from 2003 and 239% from 2000.

## Investments

We show below our common stock investments. Those that had a market value of more than \$600 million at the end of 2004 are itemized.

<u>Shares</u>	<u>Company</u>	<u>Percentage of Company Owned</u>	12/31/04	
			<u>Cost*</u> (in \$ millions)	<u>Market</u>
151,610,700	American Express Company .....	12.1	\$1,470	\$ 8,546
200,000,000	The Coca-Cola Company .....	8.3	1,299	8,328
96,000,000	The Gillette Company .....	9.7	600	4,299
14,350,600	H&R Block, Inc.....	8.7	223	703
6,708,760	M&T Bank Corporation .....	5.8	103	723
24,000,000	Moody's Corporation .....	16.2	499	2,084
2,338,961,000	PetroChina "H" shares (or equivalents)...	1.3	488	1,249
1,727,765	The Washington Post Company .....	18.1	11	1,698
56,448,380	Wells Fargo & Company.....	3.3	463	3,508
1,724,200	White Mountains Insurance.....	16.0	369	1,114
	Others .....		<u>3,531</u>	<u>5,465</u>
	Total Common Stocks .....		<u>\$9,056</u>	<u>\$37,717</u>

\*This is our actual purchase price and also our tax basis; GAAP "cost" differs in a few cases because of write-ups or write-downs that have been required.

Some people may look at this table and view it as a list of stocks to be bought and sold based upon chart patterns, brokers' opinions, or estimates of near-term earnings. Charlie and I ignore such distractions and instead view our holdings as fractional ownerships in businesses. This is an important distinction. Indeed, this thinking has been the cornerstone of my investment behavior since I was 19. At that time I read Ben Graham's *The Intelligent Investor*, and the scales fell from my eyes. (Previously, I had been entranced by the stock market, but didn't have a clue about how to invest.)

Let's look at how the *businesses* of our "Big Four" – American Express, Coca-Cola, Gillette and Wells Fargo – have fared since we bought into these companies. As the table shows, we invested \$3.83 billion in the four, by way of multiple transactions between May 1988 and October 2003. On a composite basis, our dollar-weighted purchase date is July 1992. By yearend 2004, therefore, we had held these "business interests," on a weighted basis, about 12½ years.

In 2004, Berkshire's share of the group's earnings amounted to \$1.2 billion. These earnings might legitimately be considered "normal." True, they were swelled because Gillette and Wells Fargo omitted option costs in their presentation of earnings; but on the other hand they were reduced because Coke had a non-recurring write-off.

Our share of the earnings of these four companies has grown almost every year, and now amounts to about 31.3% of our cost. Their cash distributions to us have also grown consistently, totaling \$434 million in 2004, or about 11.3% of cost. All in all, the Big Four have delivered us a satisfactory, though far from spectacular, business result.

That's true as well of our experience in the market with the group. Since our original purchases, valuation gains have somewhat exceeded earnings growth because price/earnings ratios have increased. On a year-to-year basis, however, the business and market performances have often diverged, sometimes to an extraordinary degree. During The Great Bubble, market-value gains far outstripped the performance of the businesses. In the aftermath of the Bubble, the reverse was true.

Clearly, Berkshire's results would have been far better if I had caught this swing of the pendulum. That may seem easy to do when one looks through an always-clean, rear-view mirror. Unfortunately, however, it's the windshield through which investors must peer, and that glass is invariably fogged. Our huge positions add to the difficulty of our nimbly dancing in and out of holdings as valuations swing.

Nevertheless, I can properly be criticized for merely clucking about nose-bleed valuations during the Bubble rather than acting on my views. Though I said at the time that certain of the stocks we held were priced ahead of themselves, I underestimated just how severe the overvaluation was. I talked when I should have walked.

What Charlie and I would like is a little action now. We don't enjoy sitting on \$43 billion of cash equivalents that are earning paltry returns. Instead, we yearn to buy more fractional interests similar to those we now own or – better still – more large businesses outright. We will do either, however, only when purchases can be made at prices that offer us the prospect of a reasonable return on our investment.

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We've repeatedly emphasized that the "realized" gains that we report quarterly or annually are meaningless for analytical purposes. We have a huge amount of unrealized gains on our books, and our thinking about when, and if, to cash them depends not at all on a desire to report earnings at one specific time or another. A further complication in our reported gains occurs because GAAP requires that foreign exchange contracts be marked to market, a stipulation that causes unrealized gains or losses in these holdings to flow through our published earnings as if we had sold our positions.

Despite the problems enumerated, you may be interested in a breakdown of the gains we reported in 2003 and 2004. The data reflect actual sales except in the case of currency gains, which are a combination of sales and marks to market.

<u>Category</u>	<u>Pre-Tax Gain (in \$ millions)</u>	
	<u>2004</u>	<u>2003</u>
Common Stocks .....	\$ 870	\$ 448
U.S. Government Bonds.....	104	1,485
Junk Bonds .....	730	1,138
Foreign Exchange Contracts.....	1,839	825
Other .....	<u>(47)</u>	<u>233</u>
Total .....	<u>\$3,496</u>	<u>\$4,129</u>

The junk bond profits include a foreign exchange component. When we bought these bonds in 2001 and 2002, we focused first, of course, on the credit quality of the issuers, all of which were American corporations. Some of these companies, however, had issued bonds denominated in foreign currencies. Because of our views on the dollar, we favored these for purchase when they were available.

As an example, we bought €254 million of Level 3 bonds (10 ¾% of 2008) in 2001 at 51.7% of par, and sold these at 85% of par in December 2004. This issue was traded in Euros that cost us 88¢ at the time of purchase but that brought \$1.29 when we sold. Thus, of our \$163 million overall gain, about \$85 million came from the market's revised opinion about Level 3's credit quality, with the remaining \$78 million resulting from the appreciation of the Euro. (In addition, we received cash interest during our holding period that amounted to about 25% annually on our dollar cost.)

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The media continue to report that "Buffett buys" this or that stock. Statements like these are almost always based on filings Berkshire makes with the SEC and are therefore wrong. As I've said before, the stories should say "Berkshire buys."



Portrait of a Disciplined Investor  
*Lou Simpson*

<u>Year</u>	<u>Return from GEICO Equities</u>	<u>S&amp;P Return</u>	<u>Relative Results</u>
1980 .....	23.7%	32.3%	(8.6%)
1981 .....	5.4%	(5.0%)	10.4%
1982 .....	45.8%	21.4%	24.4%
1983 .....	36.0%	22.4%	13.6%
1984 .....	21.8%	6.1%	15.7%
1985 .....	45.8%	31.6%	14.2%
1986 .....	38.7%	18.6%	20.1%
1987 .....	(10.0%)	5.1%	(15.1%)
1988 .....	30.0%	16.6%	13.4%
1989 .....	36.1%	31.7%	4.4%
1990 .....	(9.9%)	(3.1%)	(6.8%)
1991 .....	56.5%	30.5%	26.0%
1992 .....	10.8%	7.6%	3.2%
1993 .....	4.6%	10.1%	(5.5%)
1994 .....	13.4%	1.3%	12.1%
1995 .....	39.8%	37.6%	2.2%
1996 .....	29.2%	23.0%	6.2%
1997 .....	24.6%	33.4%	(8.8%)
1998 .....	18.6%	28.6%	(10.0%)
1999 .....	7.2%	21.0%	(13.8%)
2000 .....	20.9%	(9.1%)	30.0%
2001 .....	5.2%	(11.9%)	17.1%
2002 .....	(8.1%)	(22.1%)	14.0%
2003 .....	38.3%	28.7%	9.6%
2004 .....	16.9%	10.9%	6.0%
Average Annual Gain 1980-2004	20.3%	13.5%	6.8%

Even then, it is typically not I who make the buying decisions. Lou Simpson manages about \$2½ billion of equities that are held by GEICO, and it is his transactions that Berkshire is usually reporting. Customarily his purchases are in the \$200-\$300 million range and are in companies that are smaller than the ones I focus on. Take a look at the facing page to see why Lou is a cinch to be inducted into the investment Hall of Fame.

You may be surprised to learn that Lou does not necessarily inform me about what he is doing. When Charlie and I assign responsibility, we truly hand over the baton – and we give it to Lou just as we do to our operating managers. Therefore, I typically learn of Lou’s transactions about ten days after the end of each month. Sometimes, it should be added, I silently disagree with his decisions. But he’s usually right.

## Foreign Currencies

Berkshire owned about \$21.4 billion of foreign exchange contracts at yearend, spread among 12 currencies. As I mentioned last year, holdings of this kind are a decided change for us. Before March 2002, neither Berkshire nor I had *ever* traded in currencies. But the evidence grows that our trade policies will put unremitting pressure on the dollar for many years to come – so since 2002 we’ve heeded that warning in setting our investment course. (As W.C. Fields once said when asked for a handout: “Sorry, son, all my money’s tied up in currency.”)

Be clear on one point: In no way does our thinking about currencies rest on doubts about America. We live in an extraordinarily rich country, the product of a system that values market economics, the rule of law and equality of opportunity. Our economy is far and away the strongest in the world and will continue to be. We are lucky to live here.

But as I argued in a November 10, 2003 [article](#) in *Fortune*, (available at [berkshirehathaway.com](#)), our country’s trade practices are weighing down the dollar. The decline in its value has already been substantial, but is nevertheless likely to continue. Without policy changes, currency markets could even become disorderly and generate spillover effects, both political and financial. No one knows whether these problems will materialize. But such a scenario is a far-from-remote possibility that policymakers should be considering *now*. Their bent, however, is to lean toward not-so-benign neglect: A 318-page Congressional study of the consequences of unremitting trade deficits was published in November 2000 and has been gathering dust ever since. The study was ordered after the deficit hit a then-alarming \$263 billion in 1999; by last year it had risen to \$618 billion.

Charlie and I, it should be emphasized, believe that true trade – that is, the exchange of goods and services with other countries – is enormously beneficial for both us and them. Last year we had \$1.15 trillion of such honest-to-God trade and the more of this, the better. But, as noted, our country also purchased an additional \$618 billion in goods and services from the rest of the world that was unreciprocated. That is a staggering figure and one that has important consequences.

The balancing item to this one-way pseudo-trade — in economics there is always an offset — is a transfer of wealth from the U.S. to the rest of the world. The transfer may materialize in the form of IOUs our private or governmental institutions give to foreigners, or by way of their assuming ownership of our assets, such as stocks and real estate. In either case, Americans end up owning a reduced portion of our country while non-Americans own a greater part. This force-feeding of American wealth to the rest of the world is now proceeding at the rate of \$1.8 billion daily, an increase of 20% since I wrote you last year. Consequently, other countries and their citizens now own a net of about \$3 trillion of the U.S. A decade ago their net ownership was negligible.

The mention of trillions numbs most brains. A further source of confusion is that the current account deficit (the sum of three items, the most important by far being the trade deficit) and our national budget deficit are often lumped as “twins.” They are anything but. They have different causes and different consequences.

A budget deficit in no way reduces the portion of the national pie that goes to Americans. As long as other countries and their citizens have no net ownership of the U.S., 100% of our country's output belongs to our citizens under *any* budget scenario, even one involving a huge deficit.

As a rich "family" awash in goods, Americans will argue through their legislators as to how government should redistribute the national output – that is who pays taxes and who receives governmental benefits. If "entitlement" promises from an earlier day have to be reexamined, "family members" will angrily debate among themselves as to who feels the pain. Maybe taxes will go up; maybe promises will be modified; maybe more internal debt will be issued. But when the fight is finished, *all* of the family's huge pie remains available for its members, however it is divided. No slice must be sent abroad.

Large and persisting current account deficits produce an entirely different result. As time passes, and as claims against us grow, we own less and less of what we produce. In effect, the rest of the world enjoys an ever-growing royalty on American output. Here, we are like a family that consistently overspends its income. As time passes, the family finds that it is working more and more for the "finance company" and less for itself.

Should we continue to run current account deficits comparable to those now prevailing, the net ownership of the U.S. by other countries and their citizens a decade from now will amount to roughly \$11 trillion. And, if foreign investors were to earn only 5% on that net holding, we would need to send a net of \$.55 trillion of goods and services abroad *every year* merely to service the U.S. investments then held by foreigners. At that date, a decade out, our GDP would probably total about \$18 trillion (assuming low inflation, which is far from a sure thing). Therefore, our U.S. "family" would then be delivering 3% of its annual output to the rest of the world simply as tribute for the overindulgences of the past. In this case, unlike that involving budget deficits, the sons would truly pay for the sins of their fathers.

This annual royalty paid the world – which would not disappear unless the U.S. massively underconsumed and began to run consistent and large trade surpluses – would undoubtedly produce significant political unrest in the U.S. Americans would still be living very well, indeed better than now because of the growth in our economy. But they would chafe at the idea of perpetually paying tribute to their creditors and owners abroad. A country that is now aspiring to an "Ownership Society" will not find happiness in – and I'll use hyperbole here for emphasis – a "Sharecropper's Society." But that's precisely where our trade policies, supported by Republicans and Democrats alike, are taking us.

Many prominent U.S. financial figures, both in and out of government, have stated that our current-account deficits cannot persist. For instance, the minutes of the Federal Reserve Open Market Committee of June 29-30, 2004 say: "The staff noted that outsized external deficits could not be sustained indefinitely." But, despite the constant handwringing by luminaries, they offer no substantive suggestions to tame the burgeoning imbalance.

In the article I wrote for *Fortune* 16 months ago, I warned that "a gently declining dollar would not provide the answer." And so far it hasn't. Yet policymakers continue to hope for a "soft landing," meanwhile counseling other countries to stimulate (read "inflate") their economies and Americans to save more. In my view these admonitions miss the mark: There are deep-rooted structural problems that will cause America to continue to run a huge current-account deficit unless trade policies either change materially or the dollar declines by a degree that could prove unsettling to financial markets.

Proponents of the trade status quo are fond of quoting Adam Smith: "What is prudence in the conduct of every family can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage."

I agree. Note, however, that Mr. Smith's statement refers to trade of *product* for product, not of *wealth* for product as our country is doing to the tune of \$.6 trillion annually. Moreover, I am sure that he would never have suggested that "prudence" consisted of his "family" selling off part of its farm every day

in order to finance its overconsumption. Yet that is just what the “great kingdom” called the United States is doing.

If the U.S. was running a \$.6 trillion current-account *surplus*, commentators worldwide would violently condemn our policy, viewing it as an extreme form of “mercantilism” – a long-discredited economic strategy under which countries fostered exports, discouraged imports, and piled up treasure. I would condemn such a policy as well. But, in effect if not in intent, the rest of the world is practicing mercantilism in respect to the U.S., an act made possible by our vast store of assets and our pristine credit history. Indeed, the world would never let any other country use a credit card denominated in its own currency to the insatiable extent we are employing ours. Presently, most foreign investors are sanguine: they may view us as spending junkies, but they know we are *rich* junkies as well.

Our spendthrift behavior won’t, however, be tolerated indefinitely. And though it’s impossible to forecast just when and how the trade problem will be resolved, it’s improbable that the resolution will foster an *increase* in the value of our currency relative to that of our trading partners.

We hope the U.S. adopts policies that will quickly and substantially reduce the current-account deficit. True, a prompt solution would likely cause Berkshire to record losses on its foreign-exchange contracts. But Berkshire’s resources remain heavily concentrated in dollar-based assets, and both a strong dollar and a low-inflation environment are very much in our interest.

If you wish to keep abreast of trade and currency matters, read *The Financial Times*. This London-based paper has long been the leading source for daily international financial news and now has an excellent American edition. Both its reporting and commentary on trade are first-class.

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And, again, our usual caveat: macro-economics is a tough game in which few people, Charlie and I included, have demonstrated skill. We may well turn out to be wrong in our currency judgments. (Indeed, the fact that so many pundits now predict weakness for the dollar makes us uneasy.) If so, our mistake will be very public. The irony is that if we chose the opposite course, leaving all of Berkshire’s assets in dollars even as they declined significantly in value, no one would notice our mistake.

John Maynard Keynes said in his masterful *The General Theory*: “Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.” (Or, to put it in less elegant terms, lemmings as a class may be derided but never does an *individual* lemming get criticized.) From a reputational standpoint, Charlie and I run a clear risk with our foreign-exchange commitment. But we believe in managing Berkshire as if we owned 100% of it ourselves. And, were that the case, we would not be following a dollar-only policy.

### Miscellaneous

- Last year I told you about a group of University of Tennessee finance students who played a key role in our \$1.7 billion acquisition of Clayton Homes. Earlier, they had been brought to Omaha by their professor, Al Auxier – he brings a class every year – to tour Nebraska Furniture Mart and Borsheim’s, eat at Gorat’s and have a Q&A session with me at Kiewit Plaza. These visitors, like those who come for our annual meeting, leave impressed by both the city and its friendly residents.

Other colleges and universities have now come calling. This school year we will have visiting classes, ranging in size from 30 to 100 students, from Chicago, Dartmouth (Tuck), Delaware State, Florida State, Indiana, Iowa, Iowa State, Maryland, Nebraska, Northwest Nazarene, Pennsylvania (Wharton), Stanford, Tennessee, Texas, Texas A&M, Toronto (Rotman), Union and Utah. Most of the students are MBA candidates, and I’ve been impressed by their quality. They are keenly interested in business and investments, but their questions indicate that they also have more on their minds than simply making money. I always feel good after meeting them.

At our sessions, I tell the newcomers the story of the Tennessee group and its spotting of Clayton Homes. I do this in the spirit of the farmer who enters his hen house with an ostrich egg and admonishes the flock: “I don’t like to complain, girls, but this is just a small sample of what the competition is doing.” To date, our new scouts have not brought us deals. But their mission in life has been made clear to them.

- You should be aware of an accounting rule that mildly distorts our financial statements in a pain-today, gain-tomorrow manner. Berkshire purchases life insurance policies from individuals and corporations who would otherwise surrender them for cash. As the new holder of the policies, we pay any premiums that become due and ultimately – when the original holder dies – collect the face value of the policies.

The original policyholder is usually in good health when we purchase the policy. Still, the price we pay for it is always well above its cash surrender value (“CSV”). Sometimes the original policyholder has borrowed against the CSV to make premium payments. In that case, the remaining CSV will be tiny and our purchase price will be a large multiple of what the original policyholder would have received, had he cashed out by surrendering it.

Under accounting rules, we must immediately charge as a realized capital loss the excess over CSV that we pay upon purchasing the policy. We also must make additional charges each year for the amount by which the premium we pay to keep the policy in force exceeds the increase in CSV. But obviously, we don’t think these bookkeeping charges represent economic losses. If we did, we wouldn’t buy the policies.

During 2004, we recorded net “losses” from the purchase of policies (and from the premium payments required to maintain them) totaling \$207 million, which was charged against realized investment gains in our earnings statement (included in “other” in the table on page 17). When the proceeds from these policies are received in the future, we will record as realized investment gain the excess over the then-CSV.

- Two post-bubble governance reforms have been particularly useful at Berkshire, and I fault myself for not putting them in place many years ago. The first involves regular meetings of directors without the CEO present. I’ve sat on 19 boards, and on many occasions this process would have led to dubious plans being examined more thoroughly. In a few cases, CEO changes that were needed would also have been made more promptly. There is no downside to this process, and there are many possible benefits.

The second reform concerns the “whistleblower line,” an arrangement through which employees can send information to me and the board’s audit committee without fear of reprisal. Berkshire’s extreme decentralization makes this system particularly valuable both to me and the committee. (In a sprawling “city” of 180,000 – Berkshire’s current employee count – not every sparrow that falls will be noticed at headquarters.) Most of the complaints we have received are of “the guy next to me has bad breath” variety, but on occasion I have learned of important problems at our subsidiaries that I otherwise would have missed. The issues raised are usually not of a type discoverable by audit, but relate instead to personnel and business practices. Berkshire would be more valuable today if I had put in a whistleblower line decades ago.

- Charlie and I love the idea of shareholders thinking and behaving like owners. Sometimes that requires them to be pro-active. And in this arena large institutional owners should lead the way.

So far, however, the moves made by institutions have been less than awe-inspiring. Usually, they’ve focused on minutiae and ignored the three questions that truly count. First, does the company have the right CEO? Second, is he/she overreaching in terms of compensation? Third, are proposed acquisitions more likely to create or destroy per-share value?

On such questions, the interests of the CEO may well differ from those of the shareholders. Directors, moreover, sometimes lack the knowledge or gumption to overrule the CEO. Therefore, it's vital that large owners focus on these three questions and speak up when necessary.

Instead many simply follow a "checklist" approach to the issue *du jour*. Last year I was on the receiving end of a judgment reached in that manner. Several institutional shareholders and their advisors decided I lacked "independence" in my role as a director of Coca-Cola. One group wanted me removed from the board and another simply wanted me booted from the audit committee.

My first impulse was to secretly fund the group behind the second idea. Why anyone would wish to be on an audit committee is beyond me. But since directors must be assigned to one committee or another, and since no CEO wants me on his compensation committee, it's often been my lot to get an audit committee assignment. As it turned out, the institutions that opposed me failed and I was re-elected to the audit job. (I fought off the urge to ask for a recount.)

Some institutions questioned my "independence" because, among other things, McLane and Dairy Queen buy lots of Coke products. (Do they want us to favor Pepsi?) But independence is defined in Webster's as "not subject to control by others." I'm puzzled how anyone could conclude that our Coke purchases would "control" my decision-making when the counterweight is the well-being of \$8 billion of Coke stock held by Berkshire. Assuming I'm even marginally rational, elementary arithmetic should make it clear that my heart and mind belong to the owners of Coke, not to its management.

I can't resist mentioning that Jesus understood the calibration of independence far more clearly than do the protesting institutions. In Matthew 6:21 He observed: "For where your treasure is, there will your heart be also." Even to an institutional investor, \$8 billion should qualify as "treasure" that dwarfs any profits Berkshire might earn on its routine transactions with Coke.

Measured by the biblical standard, the Berkshire board is a model: (a) *every* director is a member of a family owning at least \$4 million of stock; (b) *none* of these shares were acquired from Berkshire via options or grants; (c) *no* directors receive committee, consulting or board fees from the company that are more than a tiny portion of their annual income; and (d) although we have a standard corporate indemnity arrangement, we carry no liability insurance for directors.

At Berkshire, board members travel the same road as shareholders.

\* \* \* \* \*

Charlie and I have seen much behavior confirming the Bible's "treasure" point. In our view, based on our considerable boardroom experience, the *least* independent directors are likely to be those who receive an important fraction of their annual income from the fees they receive for board service (and who hope as well to be recommended for election to other boards and thereby to boost their income further). Yet these are the very board members most often classed as "independent."

Most directors of this type are decent people and do a first-class job. But they wouldn't be human if they weren't tempted to thwart actions that would threaten their livelihood. Some may go on to succumb to such temptations.

Let's look at an example based upon circumstantial evidence. I have first-hand knowledge of a recent acquisition proposal (not from Berkshire) that was favored by management, blessed by the company's investment banker and slated to go forward at a price above the level at which the stock had sold for some years (or now sells for). In addition, a number of directors favored the transaction and wanted it proposed to shareholders.

Several of their brethren, however, each of whom received board and committee fees totaling about \$100,000 annually, scuttled the proposal, which meant that shareholders never learned of this multi-billion offer. Non-management directors owned little stock except for shares they had received from the company. Their open-market purchases in recent years had meanwhile been nominal, even though the stock had sold far below the acquisition price proposed. In other words, these directors didn't want the shareholders to be offered X even though they had consistently declined the opportunity to buy stock for their own account at a fraction of X.

I don't know which directors opposed letting shareholders see the offer. But I do know that \$100,000 is an important portion of the annual income of some of those deemed "independent," clearly meeting the Matthew 6:21 definition of "treasure." If the deal had gone through, these fees would have ended.

Neither the shareholders nor I will ever know what motivated the dissenters. Indeed they themselves will not likely know, given that self-interest inevitably blurs introspection. We do know one thing, though: At the same meeting at which the deal was rejected, the board voted itself a significant increase in directors' fees.

- While we are on the subject of self-interest, let's turn again to the most important accounting mechanism still available to CEOs who wish to overstate earnings: the non-expensing of stock options. The accomplices in perpetuating this absurdity have been many members of Congress who have defied the arguments put forth by all Big Four auditors, all members of the Financial Accounting Standards Board and virtually all investment professionals.

I'm enclosing an [op-ed piece](#) I wrote for *The Washington Post* describing a truly breathtaking bill that was passed 312-111 by the House last summer. Thanks to Senator Richard Shelby, the Senate didn't ratify the House's foolishness. And, to his great credit, Bill Donaldson, the investor-minded Chairman of the SEC, has stood firm against massive political pressure, generated by the check-waving CEOs who first muscled Congress in 1993 about the issue of option accounting and then repeated the tactic last year.

Because the attempts to obfuscate the stock-option issue continue, it's worth pointing out that no one – neither the FASB, nor investors generally, nor I – are talking about restricting the use of options in any way. Indeed, my successor at Berkshire may well receive much of his pay via options, albeit logically-structured ones in respect to 1) an appropriate strike price, 2) an escalation in price that reflects the retention of earnings, and 3) a ban on his quickly disposing of any shares purchased through options. We cheer arrangements that motivate managers, whether these be cash bonuses or options. And if a company is truly receiving value for the options it issues, we see no reason why recording their cost should cut down on their use.

The simple fact is that certain CEOs know their own compensation would be far more rationally determined if options were expensed. They also suspect that their stock would sell at a lower price if realistic accounting were employed, meaning that they would reap less in the market when they unloaded their personal holdings. To these CEOs such unpleasant prospects are a fate to be fought with all the resources they have at hand – even though the funds they use in that fight normally don't belong to them, but are instead put up by their shareholders.

Option-expensing is scheduled to become mandatory on June 15<sup>th</sup>. You can therefore expect intensified efforts to stall or emasculate this rule between now and then. Let your Congressman and Senators know what you think on this issue.

## The Annual Meeting

There are two changes this year concerning the annual meeting. First, we have scheduled the meeting for the last Saturday in April (the 30<sup>th</sup>), rather than the usual first Saturday in May. This year Mother's Day falls on May 8, and it would be unfair to ask the employees of Borsheim's and Gorat's to take care of us at that special time – so we've moved everything up a week. Next year we'll return to our regular timing, holding the meeting on May 6, 2006.

Additionally, we are changing the sequence of events on meeting day, April 30. Just as always, the doors will open at the Qwest Center at 7 a.m. and the movie will be shown at 8:30. At 9:30, however, we will go directly to the question and answer period, which (allowing for lunch at the Qwest's stands) will last until 3:00. Then, after a short recess, Charlie and I will convene the annual meeting at 3:15.

We have made this change because a number of shareholders complained last year about the time consumed by two speakers who advocated proposals of limited interest to the majority of the audience – and who were no doubt relishing their chance to talk to a captive group of about 19,500. With our new procedure, those shareholders who wish to hear it all can stick around for the formal meeting and those who don't can leave – or better yet shop.

There will be plenty of opportunity for that pastime in the vast exhibition hall that adjoins the meeting area. Kelly Muchemore, the Flo Ziegfeld of Berkshire, put on a magnificent shopping extravaganza last year, and she says that was just a warm-up for this year. (Kelly, I am delighted to report, is getting married in October. I'm giving her away and suggested that she make a little history by holding the wedding at the annual meeting. She balked, however, when Charlie insisted that he be the ringbearer.)

Again we will showcase a 2,100 square foot Clayton home (featuring Acme brick, Shaw carpet, Johns Manville insulation, MiTek fasteners, Carefree awnings and NFM furniture). Take a tour through the home. Better yet, buy it.

GEICO will have a booth staffed by a number of its top counselors from around the country, all of them ready to supply you with auto insurance quotes. In most cases, GEICO will be able to give you a special shareholder discount (usually 8%). This special offer is permitted by 45 of the 50 jurisdictions in which we operate. Bring the details of your existing insurance and check out whether we can save you money.

On Saturday, at the Omaha airport, we will have the usual array of aircraft from NetJets® available for your inspection. Stop by the NetJets booth at the Qwest to learn about viewing these planes. Come to Omaha by bus; leave in your new plane.

The Bookworm shop did a terrific business last year selling Berkshire-related books. Displaying 18 titles, they sold 2,920 copies for \$61,000. Since we charge the shop no rent (I must be getting soft), it gives shareholders a 20% discount. This year I've asked The Bookworm to add Graham Allison's *Nuclear Terrorism: The Ultimate Preventable Catastrophe*, a must-read for those concerned with the safety of our country. In addition, the shop will premiere *Poor Charlie's Almanack*, a book compiled by Peter Kaufman. Scholars have for too long debated whether Charlie is the reincarnation of Ben Franklin. This book should settle the question.

An attachment to the proxy material that is enclosed with this report explains how you can obtain the credential you will need for admission to the meeting and other events. As for plane, hotel and car reservations, we have again signed up American Express (800-799-6634) to give you special help. They do a terrific job for us each year, and I thank them for it.

At Nebraska Furniture Mart, located on a 77-acre site on 72<sup>nd</sup> Street between Dodge and Pacific, we will again be having "Berkshire Weekend" pricing. We initiated this special event at NFM eight years ago, and sales during the "Weekend" grew from \$5.3 million in 1997 to \$25.1 million in 2004 (up 45%



from a year earlier). Every year has set a new record, and on Saturday of last year, we had the largest single-day sales in NFM's history – \$6.1 million.

To get the discount, you must make your purchases between Thursday, April 28 and Monday, May 2 inclusive, and also present your meeting credential. The period's special pricing will even apply to the products of several prestigious manufacturers that normally have ironclad rules against discounting but that, in the spirit of our shareholder weekend, have made an exception for you. We appreciate their cooperation. NFM is open from 10 a.m. to 9 p.m. Monday through Saturday, and 10 a.m. to 6 p.m. on Sunday. On Saturday this year, from 5:30 p.m. to 8 p.m. we are having a special affair for shareholders only. I'll be there, eating barbeque and drinking Coke.

Borsheim's – the largest jewelry store in the country except for Tiffany's Manhattan store – will have two shareholder-only events. The first will be a cocktail reception from 6 p.m. to 10 p.m. on Friday, April 29. The second, the main gala, will be from 9 a.m. to 4 p.m. on Sunday, May 1. On Saturday, we will be open until 6 p.m.

We will have huge crowds at Borsheim's throughout the weekend. For your convenience, therefore, shareholder prices will be available from Monday, April 25 through Saturday, May 7. During that period, just identify yourself as a shareholder through your meeting credentials or a brokerage statement.

Borsheim's operates on a gross margin that is fully twenty percentage points below that of its major rivals, even before the shareholders' discount. Last year, business over the weekend increased 73% from 2003, setting a record that will be tough to beat. Show me it can be done.

In a tent outside of Borsheim's, Patrick Wolff, twice U.S. chess champion, will take on all comers in groups of six – blindfolded. Additionally, we will have Bob Hamman and Sharon Osberg, two of the world's top bridge experts, available to play with our shareholders on Sunday afternoon. They plan to keep their eyes *open* – but Bob never sorts his cards, even when playing for a national championship.

Gorat's – my favorite steakhouse – will again be open exclusively for Berkshire shareholders on Sunday, May 1, and will be serving from 4 p.m. until 10 p.m. Please remember that to come to Gorat's on that day, you must have a reservation. To make one, call 402-551-3733 on April 1 (*but not before*). If Sunday is sold out, try Gorat's on one of the other evenings you will be in town. Enhance your reputation as an epicure by ordering, as I do, a rare T-bone with a double helping of hash browns.

We will again have a special reception from 4:00 to 5:30 on Saturday afternoon for shareholders who have come from outside of North America. Every year our meeting draws many people from around the globe, and Charlie and I want to be sure we personally greet those who have come so far. Last year we enjoyed meeting more than 400 of you including at least 100 from Australia. Any shareholder who comes from other than the U.S. or Canada will be given a special credential and instructions for attending this function.

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Charlie and I are lucky. We have jobs that we love and are helped every day in a myriad of ways by talented and cheerful associates. No wonder we tap-dance to work. But nothing is more fun for us than getting together with our shareholder-partners at Berkshire's annual meeting. So join us on April 30<sup>th</sup> at the Qwest for our annual Woodstock for Capitalists.

February 28, 2005

Warren E. Buffett  
Chairman of the Board