KIM: Walk down memory lane with "Oracle of Omaha" (Part 1)

Mickey Kim
March 14, 2015

This year marks the 50-year anniversary of Warren Buffett acquiring control of Berkshire Hathaway ("Berkshire"). The recently published annual shareholder letter chronicles how Buffett came to control and transform Berkshire (www.berkshirehathaway.com).

To understand the evolution of Buffett's investment ***process***, it's important to know his history with Berkshire. I wasn't familiar with the background, so will recap and follow-up with investing lessons learned in the next column.

Buffett noted Berkshire Fine Spinning Associate's board minutes from 1954 stated the grim fact: "The textile industry in New England started going out of business forty years ago." A year later, Berkshire combined with Hathaway Manufacturing to create a company with fourteen plants and 10,000 employees. Buffett noted what started as a merger "soon morphed into a suicide pact," as the combined company lost money and closed nine plants over its first seven years.

Buffett's interest was piqued when he noticed Berkshire sometimes used the proceeds from liquidating plants to repurchase stock. In December 1962, Berkshire's stock was selling for $7.50, a huge discount to working capital (think cash) of $10.25 and book value (think assets minus liabilities) of $20.20. Buffett Partnership Ltd. ("BPL"), an investing entity managed by Buffett and comprising virtually his entire net worth (like us, he's also a big believer in eating his own cooking), started accumulating a stake that would grow to 7% of Berkshire's 1,583,680 shares outstanding by 1964.

Buffett said buying the stock at such a large discount was akin to picking up a discarded cigar butt that had one puff remaining. He said, "Though the stub might be ugly and soggy, the puff would be free."

As Buffett anticipated, Berkshire closed two additional plants and sought to repurchase shares with the proceeds. Berkshire's then CEO, Seabury Stanton, asked Buffett at what price he would sell his shares. They agreed to a price of $11.50.

Thus, Buffett was surprised when Berkshire sent a letter to shareholders on May 6, 1964 offering to buy 225,000 shares at $11.375. Irritated Stanton reneged on their deal; Buffett not only didn't sell his shares back to the company, he more than tripled BPL's stake to 392,633 shares, 39% of the 1,017,547 shares outstanding when he formally took control in April 1965.

If Buffett had tendered his shares at $11.375, BPL's gain would have been 50%. However, for want of an eighth of a point and perhaps some maturity on both sides, Stanton lost his job and Buffett found himself with 25% of BPL's capital invested in a dying business. As the result of a "monumentally stupid decision," he became "the dog who caught the car."

Ben Graham was Buffett's mentor and taught him the technique of buying mediocre businesses trading at bargain prices. Though Buffett had done well investing in these "discarded cigar butts," Charlie Munger, Berkshire Vice Chairman and Buffett's business partner for 56 years, convinced him in order to succeed investing larger sums, he needed to ***"forget what you know about buying fair businesses at wonderful prices; instead buy wonderful businesses at fair prices."*** This monumental paradigm shift would become Buffett's blueprint and lead to the value of a $1,000 investment in Berkshire when Buffett took over in 1965 increasing to ***$12.3 million*** at the end of February 2015.

Kim is the chief operating officer and chief compliance officer for Kirr Marbach & Co. LLC, an investment adviser based in Columbus, Ind. He can be reached at (812) 376-9444 or mickey@kirrmar.com.