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10 SECRETS HIDDEN IN WARREN BUFFETT'S WALLET

BY ROBERT P. MILES

Warren Buffett's 24-year-old wallet was recently purchased for $210,000 at a charity auction because it included a stock tip. But before Buffett sent his wallet to the winning bidder, he removed a significant and personal item that reveals 10 secrets to his extraordinary wealth-building success.

At a recent auction for a girl's charity, Warren Buffett's Wallet was won for a bid of $210,000 because it included a stock tip. Before he sent his 24-year-old wallet to the winning bidder, he removed a significant and personal item that reveals many secrets to his extraordinary wealth-building success. What was the item? I'll tell you in a moment.

First, let me take you back to 1969. At this time, Warren Buffett was in the process of liquidating his Buffett Partnership and focusing his time and energy on building the holding company that's known today as Berkshire Hathaway. And one of the first businesses he purchased as a wholly owned subsidiary of his new conglomerate was the Illinois National Bank, which was, at the time, the largest bank in Rockford. One of the things that makes this purchase particularly interesting is that, viewed over time, the purchase and management of the bank provides an almost picture-perfect example of the ten investment and management principles that have made Buffett the world's greatest investor.

SECRET NUMBER 1:

Invest in an old economy company that's a leader in an industry you understand.

Banking may not be the world's oldest profession, but it's *one* of the oldest, so a bank is clearly an "old economy" company. The Illinois National Bank [INB] was established in 1931 — right in the middle of the Depression — by Eugene Abegg, with a beginning net worth of $250,000 and $400,000 in deposits. By the time Abegg's bank became part of Berkshire, it wasn't only the largest in Rockford, it was also one of the most profitable in the country. And since banking is a business that Warren understands, it was a perfect match for his emerging conglomerate.

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SECRET NUMBER 2:

Invest in companies with consistent earnings.

In the 38 years before INB became a part of Berkshire, it had registered an 11.7 percent annual growth in book value and a 15.6 percent annual growth in time deposits. In its very first year, the bank earned $6,782, which set the benchmark for the company. Under Abegg's management, for nearly 50 years, the bank consistently returned two percent annually on assets. That's three times better than the average large bank, so it's not surprising that Buffett considered Abegg's management to be extraordinary.

SECRET NUMBER 3:

Pay only a reasonable price even for an outstanding business.

When Buffett bought Illinois National Bank, he paid $15.5 million for 98 percent of the business, not an insignificant amount of money. At the time, though, the bank was earning some $2 million on $100 million in deposits, and had a book value of $17 million. So Buffett bought it at 7 times earnings and less than its book value. But Warren knew exactly what he was doing. Within five and a half years Berkshire was repaid for its investment, and within eight years the bank had paid its parent company $20 million in dividends. Within a decade the bank was worth four times its original purchase price.

Buffett learned a long time ago from his mentor, Ben Graham, that "Price is what you pay, value is what you get," and he's never deviated from this investment approach. Warren paid a reasonable amount for Illinois National Bank, and value — in fact, excellent value — is what his Berkshire shareholders got.

SECRET NUMBER 4:

Buy a lot of the company, and keep it.

Contrary to popular opinion, Warren believes in concentration over diversification. Whenever he can, and if he has the money, he will buy all of a company rather than buy pieces of it through the stock market. Another one of the important lessons he learned from Ben Graham is that, whether in whole or in part, his valuation of a business and its stock are one in the same.

Warren typically purchases at least 80 percent of a wholly owned company and encourages the founder to keep a small interest in it. By retaining some ownership, the founder will be compensated based entirely on how well his particular company is doing, which will encourage him or her to focus on earnings and net worth rather than on stock prices or stock options or other businesses within the enterprise.

True to this principle, in the case of the Illinois National Bank, Buffett purchased almost all of the company. And he probably would have kept it if it hadn't been for the Federal Bank Holding Act of 1969, which was passed soon after the acquisition. As a result, in 1980, after 11 years of ownership, and as required by law, he spun off the wholly owned bank to his shareholders. Interestingly, given Buffett's philosophy, had the act not forced the liquidation of this investment, Berkshire Hathaway might have evolved quite differently and become an insurance and a banking empire.

SECRET NUMBER 5:

Invest in businesses with experienced managers in place.

When Warren Buffett bought Illinois National Bank, Eugene Abegg

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A TRIBUTE TO ONE OF THE FIRST WARREN BUFFETT CEOs: BANKER GENE ABEGG

Gene Abegg, founder of our long-owned bank in Rockford, died on July 2, 1980 at the age of 82. As a friend, banker and citizen, he was unsurpassed.

You learn a great deal about a person when you purchase a business from him and he then stays on to run it as an employee rather than as an owner. Before the purchase the seller knows the business intimately, whereas you start from scratch. The seller has dozens of opportunities to mislead the buyer — through omissions, ambiguities, and misdirection. After the check has changed hands, subtle (and not so subtle) changes of attitude can occur and implicit understandings can evaporate. As in the courtship-marriage sequence, disappointments are not infrequent.

From the time we first met, Gene shot straight 100 percent of the time — the only behavior pattern he had within him. At the outset of negotiations, he laid all negative factors face up on the table; on the other hand, for years after the transaction was completed he would tell me periodically of some previously undiscussed items of value that had come with our purchase.

Though he was already 71 years of age when he sold us the bank, Gene subsequently worked harder for us than he had for himself. He never delayed reporting a problem for a minute, but problems were few with Gene. What else would you expect from a man who, at the time of the bank holiday in 1933, had enough cash on the premises to pay all depositors in full? Gene never forgot he was handling other people's money. Though this fiduciary attitude was always dominant, his superb managerial skills enabled the bank to regularly achieve the top position nationally in profitability.

Gene was in charge of the Illinois National for close to 50 years — almost one-quarter of the lifetime of our country. George Mead, a wealthy industrialist, brought him in from Chicago to open a new bank after a number of other banks in Rockford had failed. Mr. Mead put up the money and Gene ran the show. His talent for leadership soon put its stamp on virtually every major civic activity in Rockford.

Dozens of Rockford citizens have told me over the years of help Gene extended to them. In some cases this help was financial; in all cases it involved much wisdom, empathy, and friendship. He always offered the same to me. Because of our respective ages and positions I was sometimes the junior partner, sometimes the senior. Whichever the relationship, it always was a special one, and I miss it.

**1980 Warren Buffett's Letter to Shareholders(reprinted with permission)*

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had been running the business for almost 40 year and was already 71 years old. Even so, Abegg had every intention of staying on to manage it, and Buffett wouldn't have had it any other way.

In fact, this is one of the most important elements in the development and success of Buffett's empire. Buffett buys companies with successful managers in place, and keeps them in place so they can continue running the businesses as they always have. Also, unlike other conglomerates, at Berkshire no attempt is ever made to "synergize" the acquired company into other subsidiaries and drive the founding entrepreneur out of the business.

SECRET NUMBER 6:

Leave talented managers alone to do their jobs and compliment them from a distance.

Just as one might manage a small portfolio of stocks, Buffett manages his wholly owned businesses from afar. He never takes the keys, and he never suggests how the companies should be managed. He doesn't schedule any meetings with his managers, and he doesn't expect them to submit budgets. He just leaves them alone and lets them do what they do best.

He does, however, compliment them on the job they're doing, and he does it through an annual letter to Berkshire's 300,000 shareholders. In fact, it was in his first letter to shareholders, in 1970, that he praised Eugene Abegg for the job he was doing. "Eugene Abegg," Buffett wrote, "had the problem in 1970 of topping a banner year in 1969 — and in the face of an unchanged level of deposits, managed to do it. While maintaining a position of above average liquidity, net-operating earnings before security gains came to well over two percent of average deposits. This record reflects an exceptionally well-managed banking business."

Buffett's annual letters, which are also available at his website www.berkshirehathaway.com, have become one of his primary methods of recognizing, motivating, managing, leading, and retaining talented and independently wealthy managers. And it works. Having completed over 100 acquisitions over the past 37 years, Buffett has never lost a CEO to a competing enterprise.

SECRET NUMBER 7:

Buy companies from owners who care more about who's buying the business than how much they'll get for it.

Berkshire doesn't have managers in place to run acquired businesses, so it's imperative that the founders and managers of the companies it buys stay on after the acquisition. Buffett knows that if the manager cares more about a high sale price and less about the management philosophy of the organization that's acquiring his or her creation, chances are the merger won't work. And that's because the more a manager is concerned about the purchase price, the less he or she is likely to be concerned about the company's employees. This is one of the reasons that Warren will rarely, if ever, engage in an auction for a business.

SECRET NUMBER 8:

Invest in companies whose managers are frugal and care about costs.

Warren knows that the best way to make more money is to spend less. "Our experience," he wrote in his 1978 letter to shareholders, "has been that the manager of an already high-cost operation frequently is uncommonly resourceful in finding new ways to add to overhead, while the manager of a tightly-run operation usually continues to find additional methods to curtail costs, even when his costs are already well below those of his competitors. No one," he added, "has demonstrated this latter ability better than Gene Abegg."

SECRET NUMBER 9:

Don't force experienced managers to retire.

Because he knows the value of experience, Buffett has never established a mandatory retirement age at Berkshire. In fact, the opposite policy is in effect — founders and managers are encouraged to continue painting their business masterpiece for as long as they have a passion for it. While corporate America retires its leaders at 65, Berkshire often buys companies whose managers are already over that age. Even so, while the average CEO is on the job for six years before retiring, the typical Buffett CEO has an average tenure of 23 years. Eugene Abegg was six years past typical retirement age when Illinois National Bank became part of Berkshire, and he continued to build his business for another 11 years before he passed away at the age of 82.

SECRET NUMBER 10:

Above all else, know the character of the manager.

As Warren says, he acquires managers, like Eugene Abegg, who have "every bit of the care and drive that they would have exhibited had they personally owned 100 percent of the business. No rules are necessary to enforce or even encourage this attitude; it is imbedded in the character of these managers long before selling to Berkshire. Their good character has become Berkshire's good fortune."

Like an astute banker, Buffett's genius lies in his ability to read a business owner and manager, often from the comfort of his small office in Omaha, Nebraska and determine his or her character and motivation. And the Oracle of Omaha has rarely, if ever, misjudged any of those managers. In fact, Buffett's decision to purchase the Illinois National Bank, and to bring Eugene Abegg into his company, set the standard by which to judge all of his wholly owned businesses and their CEOs. And even though it is a high standard, Warren has clearly never regretted setting it. In 1980, when Abegg died, he memorialized him in his annual letter saying, "As a friend, banker and citizen, he was unsurpassed." And that's exactly the kind of thing he would no doubt say about all the managers he's welcomed into the Berkshire Hathaway family.

So what does this have to do with Warren's wallet? Twenty years after Gene's death Warren recently wrote that he misses Abegg, one of his first Buffett CEOs. As a tribute and daily reminder, the world's most acclaimed investor revealed that he still carries a $50 bill in his wallet issued by the Illinois National Bank and signed by Eugene Abegg, possibly, he noted, the last bank CEO who's signature is on United States currency. This momento is a symbol that, to this day, represents the 10 secrets of Warren Buffett's success. ■

Robert P. Miles is a professional speaker, author, and long-term shareholder of Berkshire Hathaway.

To learn more about Robert, his powerful audio program, *How to Build Wealth Like Warren Buffett*; and books, *Warren Buffett Wealth: Principles and Practical Methods Used by the World's Greatest Investor*, *The Warren Buffett CEO: Secrets from the Berkshire Hathaway Managers* and *101 Reasons to Own the World's Greatest Investment: Warren Buffett's Berkshire Hathaway*, visit www.AdvantEdgeMag.com/006 today.