2016

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Recommended Citation

Cunningham, Lawrence A., What's Warren Buffett's Secret to Great Writing? (2016). Appears in National Association of Corporate Directors, Directorship Magazine (Summer 2016) ; GWU Law School Public Law Research Paper No. 2016-43; GWU Legal Studies Research Paper No. 2016-43. Available at SSRN: http://ssrn.com/abstract=2839887

WHAT'S WARREN BUFFETT'S SECRET TO GREAT WRITING?

Lawrence A. Cunningham

As directors increasingly ponder writing letters to shareholders, many turn to the gold standard. They wonder what most distinguishes Warren Buffett's annual missive to Berkshire Hathaway shareholders. Clarity, wit and rationality are hallmarks to emulate, along with how Buffett personally pens lengthy sections to read more as literary essays than corporate communications.

But these attractive qualities are products of a deeper distinction with greatest value. Every Buffett communiqué has a particular motivation: to attract shareholders and colleagues—including sellers of businesses—who endorse his unique philosophy. Tenets include fundamental business analysis, old-fashioned valuation methods, and a long time horizon.

A recurring motif of Buffett's writing is the classic rhetorical practice of disagreement. Buffett recites conventional wisdom along with multiple reasons why it is inaccurate or incomplete. He then differentiates Berkshire with themes like autonomy, permanence, and trust.

Parsing recent examples will show that Buffett's dispatches often work on several levels simultaneously. Think of circles on a dartboard, with the bull's-eye as Berkshire's distinctive practices, which Buffett relentlessly explains. Surrounding that core explication, in concentric circles, Buffett lauds specific Berkshire businesses or personnel, contrasts their industry or competitors, and opines on related public policy debates.

By arguing in this artful manner, Buffett hones Berkshire's corporate culture while answering rivals and critics alike. Leaving an unmistakable effect on the conglomerate's millions of owners, managers, and employees, Buffett's essays are a model of tone-at-the-top governance.

Ethics and Clayton Homes

Warren's current letter includes a 1250-word essay featuring Berkshire's Clayton Homes subsidiary. It makes and sells manufactured homes, as well as finances them through its Vanderbilt Mortgage unit. In 2003, when Berkshire acquired Clayton, Buffett excoriated its industry as "awash in problems" due to a bad business model, called securitization.

Originators of home mortgages finance lending by selling loans to investment bankers who package them into debt-like securities offered to investors. Buffett criticized this as enabling "both the retailer and manufacturer to unload terrible loans on naïve lenders" while booking profits up-front.

In 2004, chiding that the "manufactured housing industry continues to reside in the intensive care unit of Corporate America," Buffett announced a new business model: Clayton would retain all mortgages it originated or acquired from other dealers and Berkshire would fund them. He explained: "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."

After a few years of reports when Buffett referenced Clayton briefly—mostly to praise CEO Kevin Clayton as a "prototype Berkshire manager" for being "rational" and "a joy to work with"—the 2008 crisis prompted lengthy essays on it several years running. In each, Buffett championed the Berkshire-Clayton approach, chastised that of rivals, and prescribed policy responses.

Specifically, in 2008, Buffett commended Clayton's borrowers who "continued to pay normally throughout the housing crash, handing us no unexpected losses." He boasted of the Berkshire-Clayton model's simplicity and superiority:

> Why are our borrowers—characteristically people with modest incomes and far-from-great credit scores—performing so well? The answer is elementary, going right back to Lending 101. Our borrowers simply looked at how full-bore mortgage payments would compare with their actual—not hoped-for—income and then decided whether they could live with that commitment.

In 2009, Buffett said the "industry is in shambles," in part because of public policy that increases costs for its generally lower-income customers:

> The residential mortgage market is shaped by government rules that are expressed by FHA, Freddie Mac and Fannie Mae. Their lending standards are all-powerful because the mortgages they insure can typically be securitized and turned into what, in effect, is an obligation of the U.S. government. Currently buyers of conventional site-built homes who qualify for these guarantees can obtain a 30-year loan at about 5¼%. . . .
>
> In contrast, very few factory-built homes qualify for agency-insured mortgages. Therefore, a meritorious buyer of a factory-built home must pay about 9% on his loan. . . . We have tried to qualify more of our customers' loans for treatment similar to those available on the site-built product. So far we have had only token success.

Staying on message in 2010, Buffett reiterated old points in current context:

> Our borrowers get in trouble when they lose their jobs, have health problems, get divorced, etc. The recession has hit them hard. But they want to stay in their homes, and generally they borrowed sensible amounts in relation to their income. In addition, we were keeping the originated mortgages for our own account, which means we were not securitizing or otherwise reselling them. If we were stupid in our lending, we were going to pay the price. That concentrates the mind.

Buffett said less in ensuing years, but returned with vigor to the topic this year. The inspiration? Tirades against Clayton begun April 2015 in the *Seattle Times*. Writers alleged that Clayton retailers steered customers into dubious mortgages of Clayton's Vanderbilt unit, using fine-print deception and naming few or no alternative lending arrangements.

Clayton disputed every assertion while acknowledging, as Warren had, that customers facing life challenges may have difficulty repaying loans. The authors responded with a point-by-point rebuttal. At the May 2015 Berkshire shareholders' meeting five weeks later, Buffett also repudiated the piece and, again, the writers published continued skepticism.

Having written for a decade on the subject, Buffett used his March 2016 letter to update readers. Buffett stressed that Clayton thrived amid industry turmoil because, rather than securitize, it was backed by Berkshire. Buffett used a known fact as a contrast: "The funds we supplied to Goldman Sachs and General Electric [in 2008] produced headlines; the funds Berkshire quietly delivered to Clayton both made home ownership possible for thousands of families and kept many non-Clayton dealers alive."

Without citing the attacks on Clayton's disclosure, Buffett continued: "Our retail outlets, employing simple language and large type, consistently inform home buyers of alternative sources for financing." Buffett adds: "The form we use is reproduced in its actual size on page 119 [of this report]." The form defies the allegations.

While expanding upon previous denunciations of industry securitizations, Buffett highlighted unfinished public policy. He explained that the most important reform idea has not been enacted: to require mortgage originators to retain a substantial percentage rather than sell them all. In contrast, he emphasized: "At Clayton, our risk retention was, and is, 100%."

Finally, Buffett makes a personal request: "Let me talk about one subject of which I am particularly proud, that having to do with regulation." Noting increased financial industry oversight, Buffett reports governmental audits of Clayton's business and its enviable record in line with Berkshire's high standards of ethical conduct. While rivals paid "billions of dollars in fines" in the previous two years, Clayton was fined a mere $38,200 and refunded only $704,678 to customers. For context, Clayton's net income during that period was $1.2 billion. Bull's-eye.

Productivity and 3G

Berkshire culture contradicts that of private equity, which Warren has often panned for heavy meddling and lack of permanence. Yet in 2013 and 2014, Berkshire partnered with Jorge Paulo and his private equity firm, 3G, to acquire Heinz and then add Kraft—as 3G rapidly downsized both. Critics said Buffett had thus hypocritically abandoned his principles.

Buffett anticipated such commentary, in his 2013 missive giving a one-line account: "Though the Heinz acquisition has some similarities to a 'private equity,' transaction, there is a crucial difference: Berkshire never intends to sell a share of the company." In 2014, he deflected criticism by conveying that downsizing decisions were not Berkshire's but 3G's: "I'm not embarrassed to admit that Heinz is run far better under [3G's leadership] than would be the case if I were in charge."

Such was too little for some critics, however, whose persistence inspired Buffett to expand on it this year. Buffett's opening bull's-eye stated what Berkshire and 3G share: "We share with them a passion to buy, build and *hold* large businesses that satisfy basic needs and desires." The point is then tempered: "We follow different paths, however, in pursuing this goal." The 600-word essay then contrasts but strongly defends the 3G way:

> Their method, at which they have been extraordinarily successful, is to buy companies that offer an opportunity for eliminating many unnecessary costs and then—*very promptly*—to make the moves that will get the job done. Their actions significantly boost productivity, the all-important factor in America's economic growth over the past 240 years.

Buffett continues comparing and contrasting:

> At Berkshire, we, too, crave efficiency and detest bureaucracy. To achieve our goals, however, we follow an approach emphasizing *avoidance* of bloat, buying businesses . . . that have long been run by cost-conscious and efficient managers.

> After the purchase, our role is simply to create an environment in which these CEOs—and their eventual successors, who typically are like-minded—can maximize both their managerial effectiveness and the pleasure they derive from their jobs. (With this hands-off style, I am heeding a well-known Mungerism: "If you want to guarantee yourself a lifetime of misery, be sure to marry someone with the intent of changing their behavior.")

After that lighthearted quip from Berkshire's 92-year old vice chairman Charlie Munger, Buffett stands pat on Berkshire policy: "We will continue to operate with extreme—indeed, almost unheard of—decentralization at Berkshire. But we will also look for opportunities to partner with Jorge Paulo."

Changing the subject to another Berkshire virtue whose purity was not in doubt, Buffett reinforced his recurring message of Berkshire's uniqueness:

> Berkshire, however, will join only with partners making friendly acquisitions. To be sure, certain hostile offers are justified: Some CEOs forget that it is shareholders for whom they should be working, while other managers are woefully inept. In either case, directors may be blind to the problem or simply reluctant to make the change required. That's when new faces are needed. We, though, will leave these "opportunities" for others. At Berkshire, we go only where we are welcome.

While this short essay reaffirms Berkshire's preference for friendly acquisitions, it left broader criticism of firms like 3G that so "very promptly" downsize businesses acquired for that purpose. So Buffett shifted circles, adding a separate 2,100-word essay about how "root[ing] out inefficiencies . . . has been the secret sauce of America's remarkable gains in living standards since the nation's founding in 1776."

Buffett offers a history lesson dramatizing the American experience. Here, Buffett shows he's a virtuoso statistician as well as a talented writer by contrasting historical with contemporary data on productivity driving prosperity:

* farm employment fell from 40% of the workforce—11 million people—in 1900 to 2% today, while production surged: in corn, for example, output rose from 30 to 150 bushels per acre

* the railroad workforce dropped from 1.35 million after World War II to 187,000 now, as volume increased from 655 billion ton-miles of freight to 1.85 trillion

*in car insurance, the shift from agency distribution to companies selling their own policies slashed costs so much that today, at Berkshire's GEICO subsidiary, half as many workers are needed per policy as in earlier generations

* rising demand for renewables pressures electric utilities to increase efficiency—done well by Berkshire's units, having multiplied megawatt-hours of output while reducing headcount

The essay is an inspired defense of 3G's strategy of deflating bloated corporations. Detail from four industries is persuasive yet sits amid long-term trends having many causes without citing the productivity achievements of private equity.

The type and sequence of examples is alluring: while such firms have not invented a better tractor or faster train, they may innovate with new distribution systems and drive operational efficiencies—as Berkshire insurance and energy subsidiaries have done.

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Buffett's essays are rich with history, putting current debates in broad context, and steeped in statistics, anchoring argument in data. Buffett contrasts and compares; jokes and quips; and prefers to praise by name but criticize by category. Even when confronting critics, Buffett's essays avoid sounding defensive.

Above all, the work expresses who Warren is—a confident, astute and joyous capitalist. Yale University writing professor William Zinsser says that "Motivation is at the heart of writing." Buffett loves Berkshire, his curated life's work defined by unusual shareholders, adroit managers, and idiosyncratic principles. Munger has commented: "Warren's whole ego is poured into Berkshire."

More than the elements of style, such motivation is a gold standard worth aspiring to.

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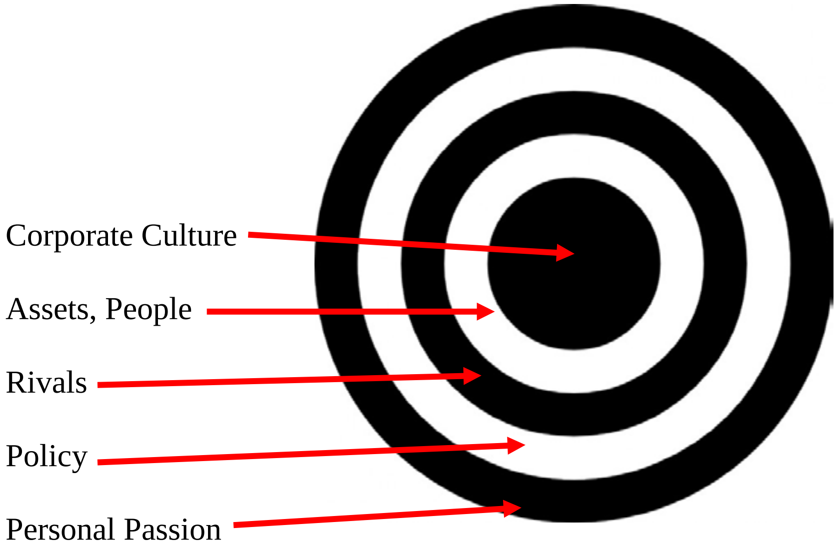
Lawrence A. Cunningham, a professor at George Washington University, has written a dozen books and hundreds of articles about business law and life, many addressing Berkshire Hathaway and Warren Buffett, including The Essays of Warren Buffett and Berkshire Beyond Buffett.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