

# Warren Buffett And I Share Our Thoughts On Life and Debt

In this Warren Buffett series, I have pulled out a few sections from the 50 years of [Berkshire Hathaway Letters to Shareholders](#) that I recently finished reading. Although the entire series was filled with a ton of business and investment wisdom, all the pieces that I have pulled for this series are from the past seven years. I will admit that it is probably due to a recency bias, whereby after reading almost 700 pages, I remember more of the recent stuff than older. Needless to say, you bet I will be reading through those letters again in the future.

This particular piece came from the [2010 shareholder letter](#).

The pieces I have pulled out are sections that resonated with me. So, below I have reproduced the part on “Life and Debt” and will annotate with my emphasis **[BOLDED]** and thoughts [\[in blue below\]](#). Then at the end, I will close with my concluding thoughts and takeaways.

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## Life and Debt

The fundamental principle of auto racing is that to finish first, you must first finish. That dictum is equally applicable to business and guides our every action at Berkshire.

Unquestionably, **some people have become very rich through the use of borrowed money. However, that’s also been a way to get very poor.** When leverage works, it magnifies your gains. Your spouse thinks you’re clever, and your neighbors get envious. But leverage is addictive. Once having profited from its wonders, very few people retreat to more conservative practices. And as we all learned in third grade – and some relearned in 2008 – any series of positive numbers, however impressive the numbers may be, evaporates when multiplied by a single zero. **History tells us that leverage all too often produces zeroes, even when it is employed by very smart people.**

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real estate, which typically requires a minimum 20% down payment. If you put the minimum 20% down like most investors would and finance the remaining 80%, you have effectively leveraged yourself 5:1. This is a great position to be in when the value is appreciating. Let's continue with this example and assume that the value of the property increases by 5% from your original acquisition price. With this sort of leverage, you are actually earning a 25% return on your equity. That sounds fantastic until you realize that leverage cuts both ways.

If the value were to instead *decrease* by 5% from your purchase price, and you are leveraged at 5:1, you would have experienced a 25% reduction in your equity position. Let's take this example a little further and assume that we have another major financial crisis that leads to a 25% reduction in the property's value, which isn't hard to imagine happening since property values sunk more than 50% in some markets in the last crisis. (Trust me. I experienced a 65% decline in our investment condo, which took the better part of eight years to get back.) In the case of a 25% decline in value, your equity position has now swung to a negative position, meaning you owe more than the house is worth.

Due to leverage, you just lost 125% of your equity. So, on a \$100,000 investment, you have actually lost \$125,000. Of course, these are all paper gains/losses if you don't have to sell. The problem with leverage is that even the smartest people that deploy it get addicted to its positive impact on returns and forget about the downside of the magnifying effect. In turn, many people end up over-leveraging themselves, making themselves very vulnerable to going bust.

I am not suggesting that leverage is evil or even that you shouldn't use it. All I am trying to drive home is that you should be both prudent and conservative in your use of leverage. There is a time and a place for it. I tend to be very conservative with my own use of leverage especially as our net worth continues to grow; I don't want to bring unnecessary risk that could do damage to all the hard work we have done to get to where we are. Leverage tends to become an Achilles heel, and I am continually reviewing our financial position through a risk mitigation lens.

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Leverage, of course, can be lethal to businesses as well. Companies with large debts **often assume that these obligations can be refinanced as they mature**. That assumption is usually valid. Occasionally, though, either because of company-specific problems or a worldwide shortage of credit, maturities must

actually be met by payment. For that, only cash will do the job.

I know Buffett was talking about businesses here, but how many individuals got caught up in the refinance mania, that played a contributing role in the '08-'09 financial crisis? People got sucked into buying houses they really couldn't afford with stupid loan programs, like the reverse amortization loan. Or they got bamboozled into signing up for the teaser rate (via an ARM loan), that once reset would result in a monthly payment that would never be affordable on their current income.

Individuals were sold on two assurances: (1) house prices are never going to go down and (2) you will always be able to refinance into a new loan with another teaser rate.

It always works...until it doesn't.

Borrowers then learn that credit is like oxygen. When either is abundant, its presence goes unnoticed. When either is missing, that's all that is noticed. Even a short absence of credit can bring a company to its knees. In September 2008, in fact, its overnight disappearance in many sectors of the economy came dangerously close to bringing our entire country to its knees.

**Charlie and I have no interest in any activity that could pose the slightest threat to Berkshire's wellbeing.** (With our having a combined age of 167, starting over is not on our bucket list.) We are forever conscious of the fact that you, our partners, have entrusted us with what in many cases is a major portion of your savings. In addition, important philanthropy is dependent on our prudence. Finally, many disabled victims of accidents caused by our insureds are counting on us to deliver sums payable decades from now. **It would be irresponsible for us to risk what all these constituencies need just to pursue a few points of extra return.**

This is exactly how I feel about debt in relation to the GYFG household, especially as we start to think about having kids. I want to make sure my wife and I and our future family have a solid financial foundation, not a house of cards that could be wiped out with the slightest of winds. We enjoy a certain lifestyle. We have goals of making work optional in the next 5-10 years. We have charitable givings that we make every month. We want to create a family legacy.

We believe we can make all this possible by maintaining a much higher savings rate (50%+ of after-tax income), **a very conservative amount of debt**, and a high income. Even if it took us a couple of extra years traveling this more conservative path, why risk having to put in an extra few decades?

It truly would be irresponsible for us to risk our dream just for a few extra points of return.

Notice I didn't say "no debt," instead I said "a very conservative amount of debt," meaning we are never going to be leveraged enough for it to cause a systemic issue to our financial well being or our long-term future. That also means it is not likely to have a very meaningful impact on our financial lives either. We make up for it by saving more than 10X the average American, and currently earning more than 6X the median household income.

A little personal history may partially explain our extreme aversion to financial adventurism. I didn't meet Charlie until he was 35, though he grew up within 100 yards of where I have lived for 52 years and also attended the same inner-city public high school in Omaha from which my father, wife, children and two grandchildren graduated. Charlie and I did, however, both work as young boys at my grandfather's grocery store, though our periods of employment were separated by about five years. My grandfather's name was Ernest, and perhaps no man was more aptly named. No one worked for Ernest, even as a stock boy, without being shaped by the experience.

~~On the facing page~~ **Below** you can read a letter sent in 1939 by Ernest to his youngest son, my Uncle Fred. Similar letters went to his other four children. I still have the letter sent to my Aunt Alice, which I found - along with \$1,000 of cash - when, as executor of her estate, I opened her safe deposit box in 1970.

Ernest never went to business school - he never in fact finished high school - but **he understood the importance of liquidity as a condition for assured survival.** At Berkshire, we have taken his \$1,000 solution a bit further and have pledged that we will hold at least \$10 billion of cash, excluding that held at our regulated utility and railroad businesses. Because of that commitment, **we customarily keep at least \$20 billion on hand so that we can both withstand unprecedented insurance losses** (our largest to date having been about \$3 billion from Katrina, the insurance industry's most expensive catastrophe) **and quickly seize acquisition or investment opportunities, even during times of financial**

## **turmoil.**

There is so much talk of how cash is trash but in crisis or when opportunities arise cash is KING. The richest man in the world is well aware of the impact of inflation eroding the purchasing power of idle cash. Yet, he continues to maintain a monster pile of cash. Buffett never wants to put the Berkshire house at risk by being caught in a moment of insufficient liquidity to service its obligations as a business.

Buffett also understands the optionality that cash brings to the table. Of course, he has made some lousy capital allocations decisions, but he has never been active for the sake of being active. If no investment presented that met his criteria, he let the cash pile build until something came along. Because of this, he tends to make much larger investments, but that is to be expected when you have the patience to wait for the FAT PITCH.

Like Buffett, I have never been afraid to hold too much cash, and like Buffett, our investments tend to be large and lumpy. A couple of recent examples include (1) [Investing 20% of our Net Worth into my company's stock](#) and (2) [Investing almost \\$80,000 over 5 months into hard money loans through PeerStreet \(about 14% of our Net Worth at the time of being fully invested\)](#).

I like to wait for the fat pitches, and I can sleep better at night knowing that we have at least a year's worth of expenses in the bank.

Everyone needs an Uncle Ernest!

Dear Fred & Catherine:

Over a period of a good many years I have known a great many people who at some time or another have suffered in various ways simply because they did not have ready cash. I have known people who have had to sacrifice some of their holdings in order to have money that was necessary at that time.

For a good many years your grandfather kept a certain amount of money where he could put his hands on it in very short notice.

For a number of years I have made it a point to keep a reserve, should some occasion come up where I would need money quickly, without disturbing the money that I have in my business. There have been a couple occasions when I found it very convenient to go to this fund.

Thus, I feel that everyone should have a reserve. I hope it never happens to you, but the chances are that some day you will need money, and need it badly, and with this thought in view, I started a fund by placing \$200.00 in an envelope, with your name on it, when you were married. Each year I added something to it, until there is now \$1000.00 in the fund.

Ten years have elapsed since you were married, and this fund is now completed.

It is my wish that you place this envelope in your safety deposit box, and keep it for the purpose that it was created for. Should the time come when you need part, I would suggest that you use as little as possible, and replace it as soon as possible.

You might feel that this should be invested and bring you an income. Forget it -- the mental satisfaction of having \$1000.00 laid away where you can put your hands on it, is worth more than what interest it might bring, especially if you have the investment in something that you could not realize on quickly.

If in after years you feel this has been a good idea, you might repeat it with your own children.

For your information, I might mention that there has never been a Buffett who ever left a very large estate, but there has never been one that did not leave something. They never spent all they made, but always saved part of what they made, and it has all worked out pretty well.

This letter is being written at the expiration of ten years after you were married.

*Edward Buffett*  
"Dad"

We keep our cash largely in U.S. Treasury bills and avoid other short-term securities yielding a few more basis points, a policy we adhered to long before the frailties of commercial paper and money market funds became apparent in September 2008. We agree with investment writer Ray DeVoe's observation, "More money has been lost reaching for yield than at the point of a gun." At Berkshire, we don't rely on bank lines, and we don't enter into contracts that could require postings of collateral except for amounts that are tiny in relation to our liquid assets.

Furthermore, not a dime of cash has left Berkshire for dividends or share repurchases during the past 40 years. Instead, we have retained all of our earnings to strengthen our business, a reinforcement now running about \$1 billion per month. Our net worth has thus increased from \$48 million to \$157 billion during those four decades and our intrinsic value has grown far more. No other American corporation has come close to building up its financial strength in this unrelenting way.

**By being so cautious in respect to leverage, we penalize our returns by a minor amount. Having loads of liquidity, though, lets us sleep well. Moreover, during the episodes of financial chaos that occasionally erupt in our economy, we will be equipped both financially and emotionally to play offense while others scramble for survival. That's what allowed us to invest \$15.6 billion in 25 days of panic following the Lehman bankruptcy in 2008.**

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## Concluding Thoughts

I tend to agree with Buffet on the above statement that over a long enough period, Berkshire's overall returns are penalized only by a minor amount due to his caution towards leverage. I would go so far as saying that he is doing the prudent thing.

I don't know about you, but I would trade in a couple hundred basis points in order to sleep soundly at night, and not have to deal with the anxiety that must accompany such large amounts of leverage in times of crisis. Too many things have to go right when using massive amounts of leverage, while the tiniest hiccup can create a domino effect that could, in the end, wipe you out completely.

We have all witnessed the devastating impact that debt can have when you over-

leverage yourself. I will continue to be very conservative when it comes to the amount of leverage the GYFG household is willing to incur. You're also not going to see me add leverage late in a positive business cycle, as I think that is a bad idea and the worst time to leverage up. In fact, I think the longer a business cycle goes before going into recession, the more critical it is to avoid leverage, if not in fact to start *deleveraging* your personal balance sheet. This is exactly what Mrs. GYFG and I are doing by [paying off our mortgage in 7 years](#) instead of the normal 30 years.

In terms of liquidity, the GYFG household will heed the advice of Uncle Ernest and will continue to maintain 6-12 months of living expenses in cash or its equivalents (like short term cd's).

### ***Let's talk about it!***

*What are your thoughts on debt and liquidity? Are you as debt adverse as Buffet and me? What other thoughts come to mind as you read this?*

- Gen Y Finance Guy



### **Gen Y Finance Guy**

**Hey, I'm Dom** - the man behind the cartoon. You'll notice that I sign off as "Gen Y Finance Guy" on all my posts, due to the fact that I write this blog anonymously (at least for now). I like to think of myself as the *Chief Freedom Officer* here of my little corner of the internet. In the real world, I'm a 30-something former C-Suite executive turned entrepreneur turned capital allocator. I am trying to humanize finance by sharing my own journey to Financial Freedom. I believe in total *honesty* and *transparency*. That is why before I ever started blogging, I decided that I would share all of my own [financial stats](#). I do this not to brag, but instead to inspire motivate, and also to hold myself accountable. My goal is to be a beacon of hope, motivation, and inspiration for *you*, the reader, by living life by example and sharing it **all** here on the blog. My sincere hope is that you will be able

to learn from me - both from my successes and my failures! [Read More](#)