

# Warren Buffett - The Basic Choices for Investors

Here is part two in this Warren Buffett series ([read part one here](#)), covering a few of the sections I have pulled out from the last 50 years of [Berkshire Hathaway Letters to Shareholders](#)<sup>x</sup>, which I finished reading in October of 2017. Although the entire 50-year series was filled with a ton of business and investment wisdom, all the pieces that I pulled are from the past seven years. I admit a probable recency bias, whereby after reading almost 700 pages, I remember more of the recent letters than the older ones. Needless to say, you bet I will be reading through *all* those letters again in the future.

For the selections in my two posts, I pulled Buffett's insights and comments that most resonated with me. I have annotated with my emphasis [**BOLDED**] and thoughts [[in blue below](#)]. At the end, I close with my concluding thoughts and takeaways. See what you think...

This second piece comes from the [2011 shareholder letter](#) "The Basic Choices for Investors and the One We Strongly Prefer:"

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## The Basic Choices for Investors and the One We Strongly Prefer

Investing is often described as the process of laying out money now in the expectation of receiving more money in the future. At Berkshire we take a more demanding approach, defining investing as the transfer to others of purchasing power now with the reasoned expectation of receiving more purchasing power – after taxes have been paid on nominal gains – in the future. More succinctly, **investing is forgoing consumption now in order to have the ability to consume more at a later date.**

[I think this is a very important definition of investing that both amateurs and professionals alike need to grasp and internalize. As we get a bit deeper into this piece, we will realize that what Buffett says constitutes an investment is a bit more complex than merely something that will increase in value over time.](#)

My hope is that by the end of this post you will be able to easily distinguish between investing and speculating. Many confuse the two as being synonymous, but I would argue that they are actually worlds apart.

I originally pulled this piece due to the thoughts outlined by Warren below in number two. It gave me an epiphany about my own confusion distinguishing gold as an investment or a speculation vehicle, but we will get into that shortly.

From our definition there flows an important corollary: The riskiness of an investment is not measured by beta (a Wall Street term encompassing volatility and often used in measuring risk) but rather by the probability – the reasoned probability – of that investment causing its owner a loss of purchasing-power over his contemplated holding period. **Assets can fluctuate greatly in price and not be risky as long as they are reasonably certain to deliver increased purchasing power over their holding period.** And as we will see, a non-fluctuating asset can be laden with risk.

Simply put, volatility does not equal risk, at least not if you're in it for the long-game. Yes, volatility can be an inconvenience, but it can also represent buying opportunities. Volatility is just a fancy word for price fluctuations. To me, this means that sometimes great companies will be overvalued, while other times they will be undervalued.

It's important to remember that the market is a **forward discounting mechanism** and that the current market price is supposed to reflect what the stock is worth today **based on its future prospects**. However, the pricing mechanism is not perfect and there are inefficiencies that occur more often than you would think.

Investment possibilities are both many and varied. There are three major categories, however, and it's important to understand the characteristics of each. So let's survey the field.

**(1)** Investments that are denominated in a given currency include money-market funds, bonds, mortgages, bank deposits, and other instruments. Most of these currency-based investments are thought of as "safe." In truth they are among the most dangerous of assets. Their beta may be zero, but their risk is huge. Over the past century these instruments have destroyed the purchasing power of investors in many countries, even as the holders continued to receive timely payments of

interest and principal. This ugly result, moreover, will forever recur. Governments determine the ultimate value of money, and systemic forces will sometimes cause them to gravitate to policies that produce inflation. From time to time such policies spin out of control.

Even in the U.S., where the wish for a stable currency is strong, the dollar has fallen a staggering 86% in value since 1965, when I took over management of Berkshire. It takes no less than \$7 today to buy what \$1 did at that time. Consequently, a tax-free institution would have needed 4.3% interest annually from bond investments over that period to simply maintain its purchasing power. Its managers would have been kidding themselves if they thought of any portion of that interest as “income.”

This letter was written in 2011, so the 86% decline in the dollar had happened over a 47 year period. If this pattern were to continue, the house I bought for \$370,000 in 2012 would be worth \$2,590,000 in the year 2058. This is hard to fathom. Or think about it this way, in the year 2058, earning \$350,000 per year would be the equivalent of earning \$50,000 per year in 2012.

So, if that friend of yours ever visits you from the future (2058) bragging about making \$350,000 right out of school, don't be too impressed. It's all relative!

I wonder if we can/will ever experience deflationary pressure to this magnitude? Is there a possibility that we stretch the limits of the financial system and cause a multi-decade depressionary cycle? How do technological advancements play into this whole thing? Does deflation have to be a bad thing? I guess it depends on the driver.

I think the most important number to relate to inflation, in that you want it to not only keep pace with inflation but to crush it, is your annual income. I personally believe you have a lot more control over your income than you do over the outcome of your investments. An aggressively increasing income will allow you to build a much larger margin of safety in the event your investments don't do as well as you had hoped. If you are able to forcefully grow your income beyond annual inflation, PLUS your investments also outpace it, then you are in a really good place.

For tax-paying investors like you and me, the picture has been far worse. During the same 47-year period, continuous rolling of U.S. Treasury bills produced 5.7% annually. That sounds satisfactory. But if an individual investor paid personal

income taxes at a rate averaging 25%, this 5.7% return would have yielded nothing in the way of real income. This investor's visible income tax would have stripped him of 1.4 points of the stated yield, and the invisible inflation tax would have devoured the remaining 4.3 points. It's noteworthy that the implicit inflation "tax" was more than triple the explicit income tax that our investor probably thought of as his main burden. "In God We Trust" may be imprinted on our currency, but the hand that activates our government's printing press has been all too human.

High interest rates, of course, can compensate purchasers for the inflation risk they face with currency-based investments - and indeed, rates in the early 1980s did that job nicely. **Current rates, however, do not come close to offsetting the purchasing-power risk that investors assume. Right now bonds should come with a warning label.**

This is a major reason why I have no allocation to bonds in the traditional sense. You could argue that by [paying down my mortgage early](#), that I am [synthetically investing in bonds](#). You could accuse and I wouldn't refuse. That said, the difference is that at the maturity of a bond, you're left with the face value, while I believe that our house's value will likely outpace inflation, and will ultimately be worth more than "face value" (i.e. what we originally paid for it). There is also the beneficial psychological aspect of not having a mortgage that is hard to quantify, as well as the financial flexibility or optionality you gain when you don't have a mortgage to service anymore.

I guess you could also argue that [by participating in hard money loans](#), that I am again exposing myself to a "currency-based investment." The question that still needs to be answered is if the 7.00% to 8.50% rates I'm receiving will be high enough to offset the purchasing-power risk I have assumed. I think they will.

**Under today's conditions, therefore, I do not like currency-based investments.** Even so, Berkshire holds significant amounts of them, primarily of the short-term variety. At Berkshire the need for ample liquidity occupies center stage and will never be slighted, however inadequate rates may be. Accommodating this need, **we primarily hold U.S. Treasury bills**, the only investment that can be counted on for liquidity under the most chaotic of economic conditions. Our working level for liquidity is \$20 billion; \$10 billion is our absolute minimum.

[I wonder if Warren Buffett was too broad in his classification here. Was he](#)

talking about all currency-based investments? Or was he really trying to focus on the “risk-free” end of the market? I certainly have no interest in investing money in T-Bills, but I do find [hard money lending through PeerStreet](#) attractive at 7% interest rates and higher. Then again, I don’t have the same liquidity needs that Berkshire has.

Beyond the requirements that liquidity and regulators impose on us, **we will purchase currency-related securities only if they offer the possibility of unusual gain** – either because a particular credit is mispriced, as can occur in periodic junk-bond debacles, or because rates rise to a level that offers the possibility of realizing substantial capital gains on high-grade bonds when rates fall. Though we’ve exploited both opportunities in the past – and may do so again – we are now 180 degrees removed from such prospects. Today, a wry comment that Wall Streeter Shelby Cullom Davis made long ago seems apt: **“Bonds promoted as offering risk-free returns are now priced to deliver return-free risk.”**

I recall a section in one of the annual reports from the 1980’s or 1990’s where Buffett purchased bonds in some type of utility that was paying double-digit returns. His thesis, that proved correct, is that the debt was mispriced and mistakenly categorized into the wrong bucket, like throwing the baby out with the bath water. We all have to acknowledge that Buffett is going to get access to deals that will never cross our desks.

**(2)** The second major category of investments involves assets that will never produce anything, but that are purchased in the buyer’s hope that someone else – who also knows that the assets will be forever unproductive – will pay more for them in the future. Tulips, of all things, briefly became a favorite of such buyers in the 17th century.

Hmm...I think you can put cryptocurrencies in this bucket. You will begin to see as Buffett describes this second category that there is not much difference between gold (see below) and bitcoin (or name your favorite digital coin). If you’re not familiar with the reference to Tulips, go check out the [Dutch Tulip Mania](#).

**This type of investment requires an expanding pool of buyers, who, in turn, are enticed because they believe the buying pool will expand still further. Owners are not inspired by what the asset itself can produce – it will remain lifeless forever – but rather by the belief that others will desire**

**it even more avidly in the future.**

Cryptocurrency anyone??? This is how I feel about all the hype in the digital currency playground.

The major asset in this category is gold, currently a huge favorite of investors who fear almost all other assets, especially paper money (of whose value, as noted, they are right to be fearful). **Gold, however, has two significant shortcomings, being neither of much use nor procreative.** True, gold has some industrial and decorative utility, but the demand for these purposes is both limited and incapable of soaking up new production. Meanwhile, if you own one ounce of gold for an eternity, you will still own one ounce at its end.

**What motivates most gold purchasers is their belief that the ranks of the fearful will grow.** During the past decade that belief has proved correct. Beyond that, the rising price has on its own generated additional buying enthusiasm, attracting purchasers who see the rise as validating an investment thesis. As “bandwagon” investors join any party, they create their own truth – for a while.

This really got my attention last October when I read it, which is why I’ve pulled it out for further reflection now on this blog. Back in 2015, on a whim, I decided that gold belonged in our portfolio. As the mania in cryptocurrencies has continued to build I have avoided this new asset class like the plague. I argued that the run-up in price is pure speculation and that there is no cash flow or production behind it. How do you value something that produces nothing?

When you invest in stocks, bonds, and real estate you are acquiring a claim to a piece of that cash flow that provides x% return on your equity. You’re hoping, over time that that cash flow will also appreciate in value as earnings expand (and hopefully at a rate faster than inflation). That doesn’t exist with cryptocurrencies. Like gold, they just represent a store of value, and due to their lack of liquidity, not a very good one in my opinion. A few weeks ago one bitcoin was worth \$18,000 and today it hit a low of \$9,000. I don’t want that kind of volatility with the money I use to pay my bills and invest, do you? When I go to the store I take comfort knowing that \$1 today is likely to be worth \$1 tomorrow (acknowledging the slow erosion due to inflation).

Having said this, I started to realize that my thinking on gold was flawed. How could I invest in gold and not bitcoin? And if I now realize that they belong in the

same category, am I not speculating by holding gold? I have reflected on this cognitive dissonance for four months and have found my answer to that question: YES. By the time this goes to press, I will have liquidated our gold position.

Over the past 15 years, both internet stocks and houses have demonstrated the extraordinary excesses that can be created by combining an initially sensible thesis with well-publicized rising prices. In these bubbles, an army of originally skeptical investors succumbed to the “proof” delivered by the market, and the pool of buyers – for a time – expanded sufficiently to keep the bandwagon rolling. **But bubbles blown large enough inevitably pop.** And then the old proverb is confirmed once again: “What the wise man does in the beginning, the fool does in the end.”

I don't know how close we are to a bubble bursting in the cryptocurrency space, but I do believe it is going to happen. Normal mom and pop investors, who can't afford to speculate in this space, are using their credit cards to invest in bitcoin. [Forbes ran an article that said almost 20% of purchases are made on a credit card.](#) And these latest “investors” are carrying a balance (paying interest) to fund their speculation, risking money they don't have.

**Today the world's gold stock is about 170,000 metric tons. If all of this gold were melded together, it would form a cube of about 68 feet per side. (Picture it fitting comfortably within a baseball infield.) At \$1,750 per ounce - gold's price as I write this - its value would be \$9.6 trillion. Call this cube pile A. Let's now create a pile B costing an equal amount. For that, we could buy all U.S. cropland (400 million acres with output of about \$200 billion annually), plus 16 Exxon Mobils (the world's most profitable company, one earning more than \$40 billion annually). After these purchases, we would have about \$1 trillion left over for walking-around money (no sense feeling strapped after this buying binge). Can you imagine an investor with \$9.6 trillion selecting pile A over pile B?**

Geez, when you put it this way, I kind of feel stupid for buying any gold at all. Point well taken!!!

Beyond the staggering valuation given the existing stock of gold, current prices make today's annual production of gold command about \$160 billion. Buyers – whether jewelry and industrial users, frightened individuals, or speculators – must continually absorb this additional supply to merely maintain an equilibrium at

present prices.

A century from now the 400 million acres of farmland will have produced staggering amounts of corn, wheat, cotton, and other crops – and will continue to produce that valuable bounty, whatever the currency may be. Exxon Mobil will probably have delivered trillions of dollars in dividends to its owners and will also hold assets worth many more trillions (and, remember, you get 16 Exxons). The 170,000 tons of gold will be unchanged in size and still incapable of producing anything. You can fondle the cube, but it will not respond.

Admittedly, when people a century from now are fearful, it's likely many will still rush to gold. **I'm confident, however, that the \$9.6 trillion current valuation of pile A will compound over the century at a rate far inferior to that achieved by pile B.**

[I think that last bolded sentence is the most important takeaway from this section.](#)

**(3)** Our first two categories enjoy maximum popularity at peaks of fear: Terror over economic collapse drives individuals to currency-based assets, most particularly U.S. obligations, and fear of currency collapse fosters movement to sterile assets such as gold. We heard “cash is king” in late 2008, just when cash should have been deployed rather than held. Similarly, we heard “cash is trash” in the early 1980s just when fixed-dollar investments were at their most attractive level in memory. On those occasions, investors who required a supportive crowd paid dearly for that comfort.

My own preference – and you knew this was coming – is our third category: **investment in productive assets, whether businesses, farms, or real estate. Ideally, these assets should have the ability in inflationary times to deliver output that will retain its purchasing-power value while requiring a minimum of new capital investment.** Farms, real estate, and many businesses such as Coca-Cola, IBM and our own See's Candy meet that double-barreled test. Certain other companies – think of our regulated utilities, for example – fail it because inflation places heavy capital requirements on them. To earn more, their owners must invest more. Even so, these investments will remain superior to nonproductive or currency-based assets.

[A productive asset from my perspective is an asset that derives its intrinsic](#)

value from its expected cash flow.

Whether the currency a century from now is based on gold, seashells, shark teeth, or a piece of paper (as today), people will be willing to exchange a couple of minutes of their daily labor for a Coca-Cola or some See's peanut brittle. **In the future the U.S. population will move more goods, consume more food, and require more living space than it does now. People will forever exchange what they produce for what others produce.**

If Warren had written this piece in 2017, I think he would have used bitcoin as an example currency above.

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So, I know my stance. I will liquidate our gold position and avoid non-productive assets. A productive asset is one that generates dividends and income for the owner, which can be delivered directly or indirectly (and in some cases both).

If I'm not willing to allocate money to gold, I have no business speculating in the cryptocurrency markets. At least not by buying digital coins. Perhaps there may be a way to invest in a company that is making real money in this space (research still to be done). **Comment below: what are your take-aways from Warren Buffett's writings? Do you agree with mine?**

- Gen Y Finance Guy

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## 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](#)