SUPERMONEY

‘ADAM
SMITH’

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For Mark O. Park

and

Susannah B. Fish

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FOREWORD

Supermoney, along with its predecessor, *The Money Game*, told the story of what came to be known as the "Go-Go" years in the U.S. stock market. It is the book that introduced Warren Buffett, now the world's most noted investor, long before he became the paradigm of investment success and homespun financial wisdom. In *Supermoney*, author "Adam Smith" travels to Omaha to meet this Will Rogers character, and later brings him on his television show, *Adam Smith's Money World*. Buffett's distinction in the Go-Go era was that he was one of the few who divined it correctly, quietly dropping out and closing the investment fund he managed. His remaining interest, in a thinly traded New England textile company, Berkshire Hathaway, would later become the vehicle for what may well be the most successful investment program of all time.

The era of speculation described in *The Money Game*—and in *Supermoney*—began in the early 1960s and was pretty much over by 1968, only to be succeeded by yet

another wave of speculation—albeit one that was starkly different in its derivation—that drove the stock market ever higher through early 1973. Then the bubble of that era burst. By the autumn of 1974 the market had fallen by 50 percent from its high, taking it back below the level it reached in 1959, 15 years earlier.

Both books reached large, eager, and well-informed audiences, deservedly earning best-seller status. In them, the author "Adam Smith" recounted perceptive, bouncing, often hilarious anecdotes about the dramatis personae of the stage show that investing had become. While *The Money Game* was essentially a study in the behavior of individual investors, *Supermoney,* as its book jacket reminded us, was about the social behavior of institutional investors, focusing on the use of "supercurrency"—income garnered through market appreciation and stock options—that became the coin of the realm during the Go-Go years.

These two books quickly became part of the lore of investing in that wild and crazy era. In retrospect, however, they provided Cassandra-like warnings about the *next* wild and crazy era, which would come, as it happens, some three decades later. The New Economy bubble of the late 1990s, followed by, yes, another 50 percent collapse in stock prices, had truly remarkable parallels with its earlier counterpart. Surely Santayana was right when he warned that "those who cannot remember the past are condemned to repeat it."

In the aftermath of that second great crash, as investors again struggle to find their bearings, the timing of this new edition of *Supermoney* is inspired. It is a thoroughly enchanting history, laced with wit and wisdom that provides useful lessons for those investors who didn't live through the Go-Go years. It also provides poignant reminiscences for those who *did* live through them. Using the insightful (but probably apocryphal) words attributed to Yogi Berra, it is "déjà vu all over again."

I consider myself fortunate to have learned the lessons of the Supermoney bubble, albeit the hard way. While I was among those who lived and lost, both personally and professionally, in that era, I summoned the strength to return and fight again. Hardened in the crucible of that experience, I reshaped my ideas about sound investing. So as the New Economy bubble inflated to the bursting point in the years before the recent turn of the century, I was one of a handful of Cassandras, urging investors to avoid concentration in the high-tech stocks of the day, to diversify to the nth degree, and to allocate significant assets to, yes, bonds.

I also consider myself fortunate to have known and worked with Jerry Goodman (the present-day Adam Smith) during this long span, having been periodically interviewed for *Institutional Investor* magazine (of which he was founding editor) and for his popular Public Broadcasting Network television show, *Adam Smith's Money World.* We served together on the Advisory Council of the Economics Department of Princeton University during the 1970s, where his strong and well-founded opinions were a highlight of our annual roundtable discussions. While I have no hesitation in acknowledging Jerry's superior mind and writing skill—a nice combination!—I console myself with our parity on the fields of combat. (*Exact* parity: Years ago, on a Princeton squash court, we were tied at 2–2 in the match and at 7–7 in the deciding game when the lights went out and the match ended.)

As one of a very few participants who has been part of the march of the financial markets during a period that has now reached 55 years—including both the Go-Go bubble of yore and the New Economy bubble of recent memory—I'm honored and delighted to contribute the foreword to this 2006 reissue of a remarkable book. I'll first discuss the excesses of the Supermoney era; next, the relentless retribution that came in its aftermath; and finally, the coming

and going of yet the most recent example of the "extraordinarily popular delusions and the madness of crowds" that have punctuated the financial markets all through history. Of course, if tomorrow's investors actually learn from the hard-won experience of their elders and the lessons of history chronicled in this wonderful volume, there will never be another bubble. But I wouldn't count on it!

Part One: The Supermoney Era

The Goodman books chronicled an era that verged on—and sometimes even crossed the line into—financial insanity: the triumph of perception over reality, of the transitory illusion of earnings (to say nothing of earnings calculations and earnings expectations) over the ultimate fundamentals of balance sheets and discounted cash flows. It was an era in which investors considered "concepts" and "trends" as the touchstones of investing, easily able to rationalize them, since they were backed by numbers, however dubious their provenance. As Goodman writes in his introduction to this new edition: ". . . people viewed financial matters as rational, because the game was measured in numbers, and numbers are finite and definitive."

During the Money Game/Supermoney era, perception was able to overwhelm reality in large measure because of financial trickery that made reality appear much better than it was. "Adam Smith" described how easy it was to inflate corporate earnings: "Decrease depreciation charges by changing from accelerated to straight line . . . change the valuation of your inventories . . . adjust the charges made for your pension fund . . . capitalize research instead of expensing it . . . defer the costs of a project until it brings in revenues . . . play with pooling and purchase (accounting) . . . all done with an eye on the stock, not on what

might be considered economic reality." And the public accountants, sitting by in silence, let the game go on. The most respected accountant of the generation, Leonard Spacek, chairman emeritus of Arthur Andersen, was almost alone in speaking out against the financial engineering that had become commonplace: "How my profession can tolerate such fiction and look the public in the eye is beyond my understanding . . . financial statements are a roulette wheel." His warning was not heeded.

The acceptance of this foolishness by the investment community was broad and deep. Writing in *Institutional Investor* in January 1968, no less an industry guru than Charles D. Ellis, then an analyst at institutional research broker Donaldson, Lufkin and Jenrette, concluded that "short-term investing may actually be safer than long-term investing sometimes, and the price action of the stocks may be more important than the 'fundamentals' on which most research is based . . . portfolio managers buy stocks, they do not 'invest' in corporations."

Yet reality, finally, took over. When it did, the stocks that were in the forefront of the bubble collapsed, fallen idols that proved to have feet of clay. Consider this table from *Supermoney*:

	Subsequent	
	High	**Low**
National Student Marketing	36	1½
Four Seasons Nursing Homes	91	0
Parvin Dohrmann	142	14
Commonwealth United	25	1
Susquehanna	80	7
Management Assistance	46	2

Stocks like these were among the favorites of mutual fund managers, and those that played the money game the hardest had the greatest near-term success. In its 1966

edition, the *Investment Companies* manual, published annually by Arthur Wiesenberger & Co. since the early 1940s, even created a special category for such funds. "Maximum Capital Gain" (MCG) funds were separated from the traditional "Long-Term Growth, Income Secondary" (LTG) funds, with remaining equity funds in the staid "Growth and Current Income" (GCI) funds category. During the Go-Go era (1963–1968 inclusive), the disparities in returns were stunning: GCI funds, +116 percent; LTG funds, +151 percent; MCG funds, a remarkable +285 percent.

At the beginning of the Go-Go era, there were 22 MCG funds; at the peak, 143. Amazingly, after its initial offering in 1966, Gerald Tsai's Manhattan Fund—a *hot* IPO in an industry that had never before had even a *warm* IPO—was placed in the LTG category. The offering attracted $250 million, nearly 15 percent of the total cash flow into equity funds for the year, and its assets would soar to $560 million within two years. Tsai was the inscrutable manager who had turned in a remarkable record in running Fidelity Capital Fund—+296 percent in 1958–1965 compared to a gain of 166 percent for the average conservative equity fund. An article in *Newsweek* epitomized Tsai's lionization: "radiates total cool . . . dazzling rewards . . . no man wields greater influence . . . king of the mutual funds." Tsai, no mean marketer, described himself as "really very conservative," and even denied that there was "such a thing as a go-go [fund]."

During the bubble of 1963–1968, equally remarkable gains were achieved by other Go-Go funds. With the S&P 500 up some 99 percent, Fidelity Trend Fund rose 245 percent, Winfield Fund leaped 285 percent, and Enterprise Fund a remarkable 643 percent. But after the 1968 peak, these funds earned unexceptional—indeed subpar—returns during the period from 1969 to 1971. Nonetheless, with their extraordinary performance during the boom

years (however achieved), their lifetime records through 1971 continued to appear extraordinary.

It was not only mutual funds that joined in the market madness. While the cupidity of fund managers could at least be understood, it was not obvious why major not-for-profit institutions also succumbed. Even the Ford Foundation added fuel to the fire, warning that, "over the long run, caution has cost our universities more than imprudence or excessive risk-taking." The poster child for imprudence was the University of Rochester's endowment fund. *Supermoney* describes its approach: "to buy the so-called great companies and not sell them," a portfolio dominated by holdings in IBM, Xerox, and Eastman Kodak. The unit value of its portfolio (presented as an appendix in *Supermoney*) soared from $2.26 in 1962 to $4.95 in 1967, and to $5.60 in 1971—an aggregate gain of 150 percent. Could it really be that easy?

Alas, if only I knew then what I know now. Lured by the siren song of the Go-Go years, I too mindlessly jumped on the bandwagon. In 1965, I was directed by Wellington Management Company chairman and founder Walter L. Morgan to "do whatever is necessary" to bring the firm that I had joined in 1951, right out of college, into the new era. I quickly engineered a merger with Boston money manager Thorndike, Doran, Paine, and Lewis, whose Ivest Fund was one of the top-performing Go-Go funds of the era. The merger was completed in 1966. In 1967 I callowly announced to our staff, "We're #1"—for during the five years ended December 31, 1966, the fund had delivered the highest total return of any mutual fund in the entire industry. So far, so good.

The story of that merger was chronicled in the lead article in the January 1968 issue of *Institutional Investor*, whose editor was none other than George J.W. Goodman. "The Whiz Kids Take Over at Wellington" described how the new partners had moved Wellington off the traditional

"balanced" investment course to a new "contemporary" course. In Wellington Fund's 1967 annual report, it was described as "dynamic conservatism" by the fund's new portfolio manager, Walter M. Cabot:

> Times change. We decided we too should change to bring the portfolio more into line with modern concepts and opportunities. We have chosen "dynamic conservatism" as our philosophy, with emphasis on companies that demonstrate the ability to meet, shape and profit from change. [We have] increased our common stock position from 64 percent of resources to 72 percent, with a definite emphasis on growth stocks and a reduction in traditional basic industries. A conservative investment fund is one that aggressively seeks rewards, and therefore has a substantial exposure to capital growth, potential profits and rising dividends . . . [one that] demands imagination, creativity, and flexibility. We will be invested in many of the great growth companies of our society. Dynamic and conservative investing is not, then, a contradiction in terms. A strong offense is the best defense.

When one of the most conservative funds in the entire mutual fund industry begins to "aggressively seek rewards," it should have been obvious that the Go-Go era was over. And it *was* over. Sadly, in the market carnage that would soon follow, the fund's strong offense, however unsurprisingly, turned out to be the *worst* defense.

Part Two: Retribution Comes

When there is a gap between perception and reality, it is only a matter of time until the gap is reconciled. But since reality is so stubborn and tolerates no gamesmanship, it is impossible for reality to rise to meet perception. So it follows that perception must decline to meet reality. *Après moi le déluge.*

The ending of the Go-Go era in 1968 was followed by a 5 percent decline in the stock market during 1969 and 1970. Even larger losses (averaging 30 percent) were incurred by the new breed of aggressive investors. But that decline was quickly offset by a 14 percent market recovery in 1971 (just as Jerry Goodman was writing *Supermoney*). In 1972, with another 19 percent gain, the market's snapback continued. For the two years combined, the market and the MCG funds produced a total return of about 35 percent.

Those final two years of the bubble reflected a subtle shift from the Go-Go era to the "Favorite Fifty" era. But that metamorphosis didn't help the other, more conservative, equity funds. Why? Because as the bubble mutated from generally smaller concept stocks to large, established companies—"the great companies" epitomized in the Rochester portfolio, sometimes called the "Favorite Fifty," sometimes the "Vestal Virgins"—the stock prices of these companies, too, lost touch with the underlying economic reality, trading at price-earnings multiples that, as it was said, "discounted not only the *future,* but the *hereafter.*"

But as 1973 began, the game ended. During the next two calendar years, the aggressive funds tumbled by almost 50 percent on average, with Fidelity Trend off 47 percent and Enterprise Fund off 44 percent. (Winfield Fund, off 50 percent in 1969–1970, was no longer around for the final carnage.) Tsai's Manhattan Fund, remarkably, did even *worse,* tumbling by 55 percent. By December 31, 1974, Manhattan Fund had provided the worst—the *worst*—eight-year record in the entire mutual fund industry: a cumulative loss of 70 percent of its shareholders' capital. In the meantime, Tsai, the failed investor but still the brilliant entrepreneur, had sold his company to CNA Insurance in 1968. By 1974, Manhattan Fund's assets had dwindled by a mere 90 percent, to $54 million, becoming a shell of its former self and a name that virtually vanished into the dustbin of market history.

And at Rochester University, the value of the endowment fund—for all the noble intentions of its managers—also plummeted. The coming of the Go-Go bubble followed by the Favorite Fifty bubble had carried its unit value from $3.17 in 1964 to $7.20 in 1972, but their going had carried it right back to $3.13 in 1974—even below where it had begun a decade earlier. *Après moi le déluge* indeed! (Reflecting the embarrassment of the Rochester managers, the cover of the endowment fund's annual report for 1974 was red, "the deepest shade we could find.")

My face was red, too. I can hardly find words to describe first my regret and then my anger at myself for having made so many bad choices. Associating myself—and the firm with whose leadership I had been entrusted—with a group of go-go managers. The stupid belief that outsized rewards could be achieved without assuming outsized risks. The naive conviction that I was smart enough to defy the clear lessons of history and select money managers who could *consistently* provide superior returns. Putting on an ill-fitting marketing hat to expand Wellington's "product line" (a phrase I have come to detest when applied to the field of money *management,* accurate today only because the fund field is now one of money *marketing,* and, ugh!, product development). I, too, had become one of the mad crowd that harbored the extraordinary popular delusions of the day.

Ultimately, alas, the merger that I had sought and accomplished not only failed to solve Wellington's problems, it exacerbated them. Despite the early glitter of success for the firm during the Go-Go years, the substance proved illusory. As a business matter, the merger worked beautifully for the first five years, but both I and the aggressive investment managers whom I had too opportunistically sought as my new partners let our fund shareholders down badly. In the great bear market of 1973–1974, stock prices declined

by a devastating 50 percent from high to low. Even for the full two-year period, the S&P 500 Index provided a total return (including dividends) of *minus* 37 percent.

Most of our equity funds did even worse. During the same period, for example, Ivest lost a shocking 55 percent of its value. In my annual chairman's letter to shareholders for 1974, I bluntly reported that "the fund's net asset value declined by 44 percent for the August 31 fiscal year. . . . Comparing this with a decline of 31 percent for the S&P 500 . . . we regard the fund's performance as unsatisfactory." (One of the fund's directors was appalled by my recognition of this seemingly self-evident fact. He soon resigned from the board.) We had also started other aggressive funds during this ebullient era. When the day of reckoning came, they, too, plummeted far more than the S&P 500: Explorer, –52 percent; Morgan Growth Fund, –47 percent; and Trustees' (!) Equity Fund, –47 percent. The latter fund folded in 1978, and a speculative fund—Technivest—that we designed to "take advantage of technical market analysis" (I'm not kidding!) folded even earlier.

Even our crown jewel, Wellington Fund, with that earlier increase in its equity ratio and a portfolio laden with "the great growth companies of our society," suffered a 26 percent loss in 1973–1974. Its record since the 1966 merger was near the bottom of the balanced fund barrel. With the average balanced fund up 23 percent for the decade, Wellington's cumulative total return *for the entire period* (including dividends) was close to *zero*—a mere 2 percent. (In 1975, portfolio manager Cabot left the firm to become manager of the Harvard Endowment Fund.)

In a business environment that was falling apart almost week by week, this terrible performance put enormous strains on the once-cooperative partnership, strains that were soon exacerbated by personal differences, conflicting ambitions and egos, and the desire to hold the reins of

power. Not surprisingly, my new partners and I had a falling-out. But they had more votes on the board, and it was *they* who fired *me* from what I had considered "my" company.

I had failed our shareholders and I had failed in my career—not in getting fired, but in jumping on the speculative bandwagon of aggressive investing in the first place. Life was fair, however: I had made a big error and I paid a high price.* I was heartbroken, my career in shambles. But I wasn't defeated. I had always been told that when a door closed (this one had slammed!), a window would open. I decided that I would open that window myself, resume my career, and change the very structure under which mutual funds operated, which was, importantly, responsible for the industry's abject failure during the Go-Go era. I would make the mutual fund industry a better place to invest.

But how could that goal be accomplished? With the essence of simplicity. Why should mutual funds retain an *outside company* to manage their affairs—then, and now, the modus operandi of our industry—when, once they reach a critical asset mass, funds are perfectly capable of managing *themselves* and saving a small fortune in fees? Why not create a structure in which mutual funds would, uniquely, be truly *mutual?* They would be run, *not* in the interest of an external adviser—a business whose goal is to earn the highest possible profit for its own separate set of owners—but in the interest of their own shareholder/owners, at the lowest possible cost. The firm would not be run

*Ironically, the original partners who fired me—those who were directly responsible for the performance problems—paid no price at all. They took full control of Wellington Management and earned enormous rewards in the great bull market that would begin in 1982. Nonetheless, they too apparently learned from their experience in the crash and ultimately restored Wellington to its earlier incarnation as a sound, respected, and conservative money manager.

on the basis of product marketing. The funds would focus, not on hot sectors of the market, but on the total market itself. The core investment philosophy would eschew the fallacy of short-term speculation and trumpet the wisdom of long-term investing. And so, on September 24, 1974, out of all the hyperbole and madness of the Go-Go era and the Favorite Fifty era, and the travail of the great crash that followed, came the creation of the Vanguard Group of Investment Companies.

Part Three: Another Bubble

One of the most engaging anecdotes in *Supermoney* is the tale of an annual investment conference in New York City that attracted some 1,500 trust officers and mutual fund managers (presumably the 1970 Conference held by *Institutional Investor* magazine). Jerry Goodman was the moderator, and as he writes, he "thought it would be a nice psychological purge after the (then) worst year of the Big Bear, if some of the previous winners could get up and confess their big sins." However good for the soul that might have been, few confessions were forthcoming. But the crowd was reminded of its sins by crusty New Englander David Babson, who described the stock market of the day as "a national craps game." His philosophy as an investment manager revolved around hard work and common sense, "virtues that would triumph in the long run."

He lashed into the assembled crowd, describing how professional investors had "gotten sucked into speculation," reading off a list, name by name, of once-vaunted stocks that had plummeted in price (from 80 to 7, 68 to 4, 46 to 2, 68 to 3, and so on), and suggesting that some of the assembled managers should leave the business. Despite Goodman's warning ("David, you have passed the pain threshold of the

audience"), Babson singled out "the new breed of investment managers who bought and churned the worst collection of new issues and other junk in history, and the underwriters who made a fortune in bringing them out . . . and elements of the financial press which promoted into new investment geniuses a group of neophytes who had . . . no sense of responsibility for managing other people's money." Babson concluded that "no greater period of skullduggery in American financial history exists than 1967 to 1969. It has burned this generation like 1929 did another one, and it will be a long, long time before it happens again."

As one might imagine, Mr. Babson's remarks were not well received by the audience of money managers. But while he failed to foresee a second leg of the bubble (the Favorite Fifty era) that would quickly follow, he was right. Just as some 35 years had elapsed from 1929 until the start of the Go-Go era in 1965, so some 33 years would elapse before the next bubble emerged. Once again, a new generation would forget the lessons learned by its predecessors.

Some of the causes of the new bubble were the same. (They may be eternal.) David Babson had listed them: "Accountants who played footsie with stock-promoting managements by classifying earnings that weren't earnings at all. 'Modern' corporate treasurers who looked upon their company pension funds as new-found profit centers . . . mutual fund managers who tried to become millionaires overnight by using every gimmick imaginable to manufacture their own paper performance . . . security analysts who forgot about their professional ethics to become storytellers and let their institutions be taken in by a whole parade of confidence men." Charles Ellis's 1968 insight that "portfolio managers buy stocks, they do not 'invest' in corporations" also came back to haunt us. (With a twist, of course. Managers didn't merely buy stocks; they *traded* them with unprecedented ferocity.)

If you conclude that *the more things change, the more they remain the same,* you get my point. But each bubble has its own characteristics, too, and the bubble of the late 1990s added a host of new elements to the eternal equation. Part of the bullish thesis underlying that bubble (as it was described by *WIRED* magazine) was based on a heavy dose of rose-colored vision: "the triumph of the United States, the end of major wars, waves of new technology, soaring productivity, a truly global market, and corporate restructuring—a virtuous circle . . . driven by an open society in an integrated world." And there was more: the excitement accompanying the turn of the millennium that would begin in 2001 (even though most people celebrated it on January 1, 2000); the "information age" and the technology revolution; the (once-capitalized) "new economy." Together, these powerful changes seemed to hold the prospects of extraordinary opportunity. And so, once again, investors lost their perspective.

Why should that surprise us? After all, way back in the second century B.C.E. the Roman orator Cato warned us:

> There must certainly be a vast Fund of Stupidity in Human Nature, else Men would not be caught as they are, a thousand times over, by the same Snare, and while they yet remember their past Misfortunes, go on to court and encourage the Causes to which they were owing, and which will again produce them.

After my experience in the earlier bubble, I hardly needed Cato's warning. Late in March of 2000—within days of the stock market's hyperinflated peak—I was writing a speech that would soon warn a gathering of institutional investors in Boston that we could well be "caught in one of those periodic snares set by the limitless supply of stupidity in human nature. . . . Professional investors who ignore today's rife signs of market madness—of a bubble, if you

will—are abrogating their fiduciary duty, and dishonoring their responsibility for the stewardship of their clients' assets."

"How should that responsibility be honored?" I asked. "By recognizing that, for all of the projections and assumptions we make (and almost take for granted) . . . stock market returns are completely unpredictable in the short run and—unless we know more about the world 25 years from now than we do about the world today—may prove even less predictable over the long-run. The problem is that future expectations often lose touch with future reality. Sometimes hope rides in the saddle, sometimes greed, sometimes fear. No, there is no 'new paradigm.' Hope, greed, and fear make up the market's *eternal* paradigm."

In the speech, I also noted that,"by almost any conventional measure of stock valuation, stocks have never been riskier than they are today," pointing out that major market highs were almost invariably signaled when the dividend yield on stocks fell below 3 percent, when the price-earnings ratio rose much above 20 times earnings, and when the aggregate market value of U.S. equities reached 80 percent of our nation's gross domestic product (GDP). "Yet today," I warned, "dividend yields have fallen to just over 1 percent . . . stocks are now selling at something like 32 times last year's earnings . . . and the equity market value has almost reached 200 percent of GDP. (Just be patient!) Clearly, if past data mean anything, risk is the forgotten man of this Great Bull Market."

The disquieting similarities between the Go-Go era and the recent technology-driven market also caught my attention. In the course of my remarks, I presented the exhibit below to show the striking parallels between the huge upside returns of the aggressive funds of each era and the enormous capital inflows that they enjoyed when

investors—as always, late to the game—chased those returns.

Déjà vu?
Comparison of Go-Go Era to Tech-Boom Era

	5 Large Go-Go Funds		5 Large Tech Funds
1963–1968		1997–2000	
Fund return	344%	Fund return	403%
S&P return	99	S&P return	92
Ratio	3.4 x	Ratio	4.3 x
1963 assets	$200 M	1997 assets	$5.6 B
1968 assets	3.4 B	2000 assets	40 B
Increase	17 x	Increase	7 x
1969–1974		2000–2005	
Fund return	–45%	Fund return	?
S&P return	–19	S&P return	?
Ratio	2.4 x	Ratio	?

My conclusion:

> So, let me be clear: You can place me firmly in the camp of those who are deeply concerned that the stock market is all too likely to be riding for a painful fall—indeed a fall that may well have begun as I began to write this speech ten days ago. From Milton Friedman to Robert Shiller (author of the newly published *Irrational Exuberance*), to John Cassidy of *The New Yorker,* and Steven Leuthold, Jeremy Grantham, Jeremy Siegel, Julian Robertson (who just threw in the towel), Gary Brinson (whose convictions may have cost him his job), and Alan Greenspan (whose convictions haven't). Viewed a decade hence, today's stock market may just be one more chapter in *Extraordinary Popular Delusions and the Madness of Crowds.*

As it turned out, the painful fall *had* begun, on March 10, 2000, just as I began to write that speech. (There's luck in that; while we often know *what* will happen in the stock market, we never know *when.*) But what about those three question marks about *future* returns that I posted in the lower right corner of the exhibit? Again, the similarities to the earlier bubble were to prove stunning. While the S&P 500 was off just 7 percent in 2000–2005, the total return of the average large technology fund was a staggering *minus* 58 percent. "History may not repeat itself," in Mark Twain's wise formulation, "but it rhymes."

So, dear reader, learn from the wonderful history you are about to read. Enjoy a fast-moving page-turner about a wild and crazy era, the kind of era that, as Cato warned us, repeats itself over and over again. Profit from the lessons of the past that "Adam Smith" so vividly brings to life in *Supermoney.* Profit too, if you will, from my own personal and professional failures, and learn from them the easy way rather than the hard way that was my lot. (Not that, after a long and character-building struggle, it didn't have a wonderful outcome!) Above all, heed the idealistic goal set by John Maynard Keynes 70 years ago, quoted at length in *Supermoney:*

> (While) the actual private object of most skilled investors today . . . is a battle of wits to anticipate the basis of conventional valuation a few months hence . . . the social object of investment should be to defeat the dark forces of time and ignorance which envelop our future.

John C. Bogle
Valley Forge, Pennsylvania
January 11, 2006

Preface to the 2006 Edition

Who's Warren Buffett? What Is Supermoney?

The handwritten letter appeared in 1970; it was from "La Champouse," 42 Avenue de Marseille, Aix-en-Provence. Benjamin Graham was living in the South of France, retired, with his lady friend, and translating Greek and Latin classics. That was a favorite avocation. The prescript of *Security Analysis,* the forbidding black bible of security analysts, is from Horace: "Many shall be restored that are now fallen and many shall fall that are now in honor."

I hadn't known him, but I had written some sentences about him in *The Money Game*. Graham, I had written, was "the dean of our profession, if security analysis can be said to be a profession. The reason that Graham is the undisputed dean is that before him there was no profession and after him they began to call it that."

Graham liked being called "the dean." He corrected, in Greek, a sentence in my book that no one had checked, and one or two other references. He said he had something in mind to discuss when he came to New York.

Shortly thereafter, he did appear in New York, to see a publisher about his translation of Aeschuylus and to see his grandchildren. I asked him what he thought of the market. *Hoc etiam transibit*, he said, "This too shall pass."

Graham said he wanted me to work on the next edition of *The Intelligent Investor*, the popular version of his textbook. "There are only two people I would ask to do this," he said. "You are one, and Warren Buffett is the other."

"Who's Warren Buffett?" I asked. A natural question. In 1970 Warren Buffett wasn't known outside of Omaha, Nebraska, or Ben Graham's circle of friends.

Today, Warren is so well known that when newspapers mention him they sometimes need no phrase in apposition to identify him, or if they do, they say simply, "the investor." There are full-length biographies on the shelves. He is indeed "the investor," one of the best in history. Investing has made him the second-richest person in the country, behind his bridge buddy Bill Gates.

Even in 1970, Warren had an outstanding investment record, and with an unfashionable technique. He had started an investment partnership in 1956 with $105,000 from friends and relatives. When he terminated the partnership in 1969, it had $105 million and had compounded at 31 percent. Warren's performance fee meant he was worth about $25 million. He ended the partnership because he said he couldn't understand the stock market anymore.

I was not the right author to work on the next edition of *The Intelligent Investor*. I was an acolyte of Sam Stedman (not the mutual funds or the bridge conventions) by way of Phil Fisher. Stedman's investment philosophy, loosely called "growth," said you should find a couple of rapidly growing companies whose growth rates were secure. The companies would have a competitive advantage because of their patent protection or impregnable market positions;

they would have three years of earning visibility; and you would buy them at less than their growth rates, because their prices would seem high compared to the average stock and they paid no dividends.

The machine that addicted us to growth investing was the Xerox 914. It was the first machine to copy plain paper, and I can remember writing that some day people would use the word *Xerox* as a verb. That seemed radical at the time. Xerox was a ten-bagger, and once you have a ten-bagger, everything else seems tame. The Xerox crowd even got to play the game again, with Rank Xerox in the United Kingdom and Fuji Xerox in Japan.

We all went to Dunhill on 57th Street and had suits tailored where the four buttons on the sleeves had real buttonholes. We did not think much about Ben Graham. Charming as he was, he had written, in 1949, that he could not buy IBM because its price precluded the "margin of safety which we consider essential to a true investment."

At Graham's urging, I had several conversations with Warren, and then I flew to Omaha to meet him, even though I still didn't think I was right for the job. We had a steak dinner. We had a bacon, eggs, and potatoes breakfast. We got along famously. Warren was, and is, cheerful and funny. He has a gift of metaphor that is irresistible. And, as everybody now knows, he is very smart.

Warren didn't look like the Xerox crowd. While he wore a suit and a tie, his wrists emerged from the sleeves, revealing an indifference to tailoring. (Today, as our senior financial statesman, he is dressed impeccably, but without, I suspect, intense interest in the process.) To a member of the Xerox crowd then, he looked like he had fallen off the turnip truck.

I went to Warren's house on Farnam Street, which he had bought for $31,500 in 1958. It was a rambling, comfortable house. He had added a racquetball court to it.

How, I wanted to know, could he operate from Omaha? In New York, the portfolio managers were all trading stories at breakfast, lunch, and dinner.

"Omaha gives me perspective," Warren said. He showed me a write-up from a Wall Street firm that said, "Securities must be studied on a minute-by-minute program."

"Wow!" Warren said. "This sort of stuff makes me feel guilty when I go out for a Pepsi."

I couldn't interest Warren in the truffle hunt for the next Xerox. Our growth crowd was sniffing everywhere, talking to vendors, customers, competitors, the Phil Fisher geometry. Not that Warren didn't do research his own way.

For example, Warren noticed that the bonds of the Indiana Turnpike were selling in the 70s, while the nearly identical bonds of the Illinois Turnpike sold in the 90s. The casual word among the bond crowd was that the maintenance allowance wasn't high enough behind the Indiana bonds.

Warren got into his car and drove the length of the Indiana Turnpike. Then he went to Indianapolis and turned the pages of the maintenance reports of the highway department. He thought the Indiana Turnpike didn't need that much work, and bought the bonds. They closed the gap with the bonds of the Illinois Turnpike. Not exactly the next Xerox.

Warren showed me the principles he had written out on a lined, yellow legal pad and framed:

> *a. Our investments will be chosen on the basis of value, not popularity.*
>
> *b. Our investments will attempt to reduce the risk of permanent capital loss (not short-term quotation loss) to a minimum.*
>
> *c. My wife, children and I will have virtually our entire net worth in the partnership.*

Warren had ended his partnership, so I couldn't have bought into it anyway. The partnership had bought shares in an old New England textile company, Berkshire Hathaway, and that stock was traded in the "pink sheets." I looked up Berkshire. It seemed to be a failing New England textile company.

"Berkshire is hardly going to be as profitable as Xerox in a hypertense market," Warren wrote to his investors, "but it is a very comfortable thing to own. We will not go into a business where technology which is way over my head is crucial to the decision." Berkshire's attraction was that it had $18 in net working capital, and Buffett's investors had paid $13.

I didn't buy Berkshire Hathaway. At the end of my stay, I said I didn't want to work on Ben Graham's book. Warren said he didn't either. We wrote a note to Ben saying his book didn't really need any improvements.

The little story about Ben and Warren went into this book. The original publisher, Random House, gave a party for the book. Warren came to the party, and had a good time. We have the pictures. My hair is embarrassingly long, and Warren's haircut looks, well, mid-America. We kept in touch.

"Who's Warren Buffett?" the people at The Washington Post Company asked when Warren bought a stake. They ordered 50 copies of *Supermoney*.

I tried the Washington Post idea on my Wall Street friends. They couldn't see it.

"Big city newspapers are dead," they said. "The trucks can't get through the streets. Labor problems are terrible. People get their news from television." And anyway, it wasn't the next Xerox.

In 1976, Rupert Murdoch's News Corp launched an unfriendly takeover of The New York Magazine Company. I had been one of its founders, with 5-cent stock. We had spent eight years building a unique property. We not only

had *New York Magazine*, but also the *Village Voice* and a California magazine called *New West*. Now Murdoch had bought 50.1 percent of the stock.

I called up Warren and whined.

"You want it back?" he asked.

I got very attentive. He sent me News Corp's annual report. It was full of British or Australian accounting terminology. I didn't get it.

"News Corp has a market cap of only $50 million," Warren said. "For $27 million, you could have two big newspapers in Australia, 73 weekly newspapers in Britain, two television stations, 20 percent of Ansett Airlines, and you'd have your magazine back."

"How do we do it?" I asked.

"What is this *we*, kemosabe?" Warren said, using a term from our radio days with *The Lone Ranger.* "You want your magazine back, I'm telling you how to do it."

"But Murdoch controls News Corp," I said.

"You didn't read carefully," Warren said. "Look at footnote 14. Clarendon has 40 percent. The rest is Australian institutions. Clarendon is Murdoch and his four sisters. I figure it would take one sister and the float and a year in Australia, and guess which one of us is going to spend the year in Australia?"

I didn't go, and we didn't get the property back, either. I should have bought News Corp. Murdoch sold our magazines for many times what he had paid in the raid.

When we launched the weekly *Adam Smith* television show, we took it to Omaha right away. It was the first TV Warren had done, and for a long time, the only TV. It didn't take much to get Warren to use his baseball metaphors.

"When I look at the managers who run my companies, I feel like Miller Huggins looking at his lineup of the 1927 Yankees." (Those were the Yankees, of course, with Babe Ruth and Lou Gehrig.)