1958 Letter
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THE GENERAL STOCK MARKET IN 1958

A friend who runs a medium-sized investment trust recently wrote: "The mercurial temperament, characteristic of the American people, produced a major transformation in 1958 and 'exuberant' would be the proper word for the stock market, at least".

I think this summarizes the change in psychology dominating the stock market in 1958 at both the amateur and professional levels. During the past year almost any reason has been seized upon to justify "Investing" in the market. There are undoubtedly more mercurially-tempered people in the stock market now than for a good many years and the duration of their stay will be limited to how long they think profits can be made quickly and effortlessly. While it is impossible to determine how long they will continue to add numbers to their ranks and thereby stimulate rising prices, I believe it is valid to say that the longer their visit, the greater the reaction from it.

I make no attempt to forecast the general market - my efforts are devoted to finding undervalued securities. However, I do believe that widespread public belief in the inevitability of profits from investment in stocks will lead to eventual trouble. Should this occur, prices, but not intrinsic values in my opinion, of even undervalued securities can be expected to be substantially affected.

RESULTS IN 1958

In my letter of last year, I wrote:

"Our performance, relatively, is likely to be better in a bear market than in a bull market so that Deductions made from the above results should be tempered by the fact that it was the type of year when we should have done relatively will. In a year when the general market had a substantial advance, I would be well satisfied to match the advance of the averages."

The latter sentence describes the type of year we had in 1958 and my forecast worked out. The Dow-Jones Industrial average advanced from 435 to 583 which, after adding back dividends of about 20 points, gave an overall gain of 38.5% from the Dow-Jones unit. The five partnerships that operated throughout the entire year obtained results averaging slightly better than this 38.5%. Based on market values at the end of both years, their gains ranged from 36.7% to 46.2%. Considering the fact that a substantial portion of assets has been and still is invested in securities, which benefit very little from a fast-rising market, I believe these results are reasonably good. I will continue to forecast that our results will be above average in a declining or level market, but it will be all we can do to keep pace with a rising market.

TYPICAL SITUATION

So that you may better understand our method of operation, I think it would be well to review a specific activity of 1958. Last year I referred to our largest holding which comprised 10% to 20% of the assets of the various partnerships. I pointed out that it was to our interest to have this stock decline or remain relatively steady, so that we could acquire an even larger position and that for this reason such a security would probably hold back our comparative performance in a bull market

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This stock was the Commonwealth Trust Co. of Union City, New Jersey. At the time we started to purchase the stock, it had an intrinsic value $125 per share computed on a conservative basis. However, for good reasons, it paid no cash dividend at all despite earnings of about $10 per share which was largely responsible for a depressed price of about $50 per share. So here we had a very well managed bank with substantial earnings power selling at a large discount from intrinsic value. Management was friendly to us as new stockholders and risk of any ultimate loss seemed minimal.

Commonwealth was 25.5% owned by a larger bank (Commonwealth had assets of about $50 Million – about half the size of the First National in Omaha), which had desired a merger for many years. Such a merger was prevented for personal reasons, but there was evidence that this situation would not continue indefinitely. Thus we had a combination of:

1. Very strong defensive characteristics;
2. Good solid value building up at a satisfactory pace and;
3. Evidence to the effect that eventually this value would be unlocked although it might be one year or ten years. If the latter were true, the value would presumably have been built up to a considerably larger figure, say, $250 per share.

Over a period of a year or so, we were successful in obtaining about 12% of the bank at a price averaging about $51 per share. Obviously it was definitely to our advantage to have the stock remain dormant in price. Our block of stock increased in value as its size grew, particularly after we became the second largest stockholder with sufficient voting power to warrant consultation on any merger proposal.

Commonwealth only had about 300 stockholders and probably averaged two trades or so per month, so you can understand why I say that the activity of the stock market generally had very little effect on the price movement of some of our holdings. Unfortunately we did run into some competition on buying, which railed the price to about $65 where we were neither buyer nor seller. Very small buying orders can create price changes of this magnitude in an inactive stock, which explains the importance of not having any "Leakage" regarding our portfolio holdings.

Late in the year we were successful in finding a special situation where we could become the largest holder at an attractive price, so we sold our block of Commonwealth obtaining $80 per share although the quoted market was about 20% lower at the time.

It is obvious that we could still be sitting with $50 stock patiently buying in dribs and drabs, and I would be quite happy with such a program although our performance relative to the market last year would have looked poor. The year when a situation such at Commonwealth results in a realized profit is, to a great extent, fortuitous. Thus, our performance for any single year has serious limitations as a basis for estimating long term results. However, I believe that a program of investing in such undervalued well protected securities offers the surest means of long term profits in securities.

I might mention that the buyer of the stock at $80 can expect to do quite well over the years. However, the relative undervaluation at $80 with an intrinsic value $135 is quite different from a price $50 with an intrinsic value of $125, and it seemed to me that our capital could better be employed in the situation which replaced it.

This new situation is somewhat larger than Commonwealth and represents about 25% of the assets of the various partnerships. While the degree of undervaluation is no greater than in many other securities we own (or even than some) we are the largest stockholder and this has substantial advantages many times in determining the length of time required to correct the undervaluation. In this particular holding we are virtually assured of a performance better than that of the Dow-Jones for the period we hold it.

THE CURRENT SITUATION

The higher the level of the market, the fewer the undervalued securities and I am finding some difficulty in securing an adequate number of attractive investments. I would prefer to increase the percentage of our assets in work-outs, but these are very difficult to find on the right terms.

To the extent possible, therefore, I am attempting to create my own work-outs by acquiring large positions in several undervalued securities. Such a policy should lead to the fulfillment of my earlier forecast – an above average performance in a bear market. It is on this basis that I hope to be judged. If you have any questions, feel free to ask them.

WARREN E. BUFFETT 2-11-59