The Francis Forum

Create Wealth, Achieve Freedom **Spring Edition 2014**

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Warren Buffett's Annual Letter: What You can learn from my Real Estate Investments

"Investment is most intelligent when it is most businesslike." --Benjamin Graham*, The Intelligent Investor*

"It is fitting to have a Ben Graham quote open this essay because I owe so much of what I know about investing to him. I will talk more about Ben a bit later, and I will even sooner talk about common stocks. But let me first tell you about two small non-stock investments that I made long ago. Though neither changed my net worth by much, they are instructive.

This tale begins in Nebraska. From 1973 to 1981, the Midwest experienced an explosion in farm prices, caused by a widespread belief that runaway inflation was coming and fueled by the lending policies of small rural banks. Then the bubble burst, bringing price declines of 50% or more that devastated both leveraged farmers and their lenders. Five times as many Iowa and Nebraska banks failed in that bubble's aftermath as in our recent Great Recession.

In 1986, I purchased a 400-acre farm, located 50 miles north of Omaha, from the FDIC. It cost me $280,000, considerably less than what a failed bank had lent against the farm a few years earlier. I knew nothing about operating a farm. But I have a son who loves farming, and I learned from him both how many bushels of corn and soybeans the farm would produce and what the operating expenses would be. From these estimates, I calculated the normalized return from the farm to then be about 10%. I also thought it was likely that productivity would improve over time and that crop prices would move higher as well. Both expectations proved out.

I needed no unusual knowledge or intelligence to conclude that the investment had no downside and potentially had substantial upside. There would, of course, be the occasional bad crop, and prices would sometimes disappoint. But so what? There would be some unusually good years as well, and I would never be under any pressure to sell the property. Now, 28 years later, the farm has tripled its earnings and is worth five times or more what I paid. I still know nothing about farming and recently made just my second visit to the farm.

In 1993, I made another small investment. Larry Silverstein, Salomon's landlord when I was the company's CEO, told me about a New York retail property adjacent to New York University that the Resolution Trust Corp. was selling. Again, a bubble had popped -- this one involving commercial real estate -- and the RTC had been created to dispose of the assets of failed savings institutions whose optimistic lending practices had fueled the folly."

This insightful article continues over the next few pages.

As always, I'm always available to discuss the topics in my newsletter, or any other financial inquiries you may have.

Sincerely, Duane

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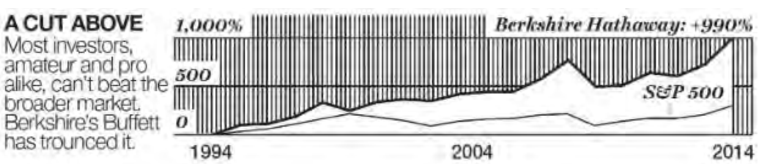
"Here, too, the analysis was simple. As had been the case with the farm, the unleveraged current yield from the property was about 10%. But the property had been under-managed by the RTC, and its income would increase when several vacant stores were leased. Even more important, the largest tenant -- who occupied around 20% of the project's space -- was paying rent of about $5 per foot, whereas other tenants averaged $70. The expiration of this bargain lease in nine years was certain to provide a major boost to earnings. The property's location was also superb: NYU wasn't going anywhere.



I joined a small group -- including Larry and my friend Fred Rose -- in purchasing the building. Fred was an experienced, high-grade real estate investor who, with his family, would manage the property. And manage it they did. As old leases expired, earnings tripled. Annual distributions now exceed 35% of our initial equity investment. Moreover, our original mortgage was refinanced in 1996 and again in 1999, moves that allowed several special distributions totaling more than 150% of what we had invested. I've yet to view the property.

Income from both the farm and the NYU real estate will probably increase in decades to come. Though the gains won't be dramatic, the two investments will be solid and satisfactory holdings for my lifetime and, subsequently, for my children and grandchildren.

I tell these tales to illustrate certain fundamentals of investing:

- You don't need to be an expert in order to achieve satisfactory investment returns. But if you aren't, you must recognize your limitations and follow a course certain to work reasonably well. Keep things simple and don't swing for the fences. When promised quick profits, respond with a quick "no."

Focus on the future productivity of the asset you are considering. If you don't feel comfortable making a rough estimate of the asset's future earnings, just forget it and move on. No one has the ability to evaluate every investment possibility. But omniscience isn't necessary; you only need to understand the actions you undertake.

- If you instead focus on the prospective price change of a contemplated purchase, you are speculating. There is nothing improper about that. I know, however, that I am unable to speculate successfully, and I am skeptical of those who claim sustained success at doing so. Half of all coin-flippers will win their first toss; none of those winners has an expectation of profit if he continues to play the game. And the fact that a given asset has appreciated in the recent past is never a reason to buy it.

- With my two small investments, I thought only of what the properties would produce and cared not at all about their daily valuations. Games are won by players who focus on the playing field -- not by those whose eyes are glued to the scoreboard. If you can enjoy Saturdays and Sundays without looking at stock prices, give it a try on weekdays.

- Forming macro opinions or listening to the macro or market predictions of others is a waste of time. Indeed, it is dangerous because it may blur your vision of the facts that are truly important. (When I hear TV commentators glibly opine on what the market will do next, I am reminded of Mickey Mantle's scathing comment: "You don't know how easy this game is until you get into that broadcasting booth.")

My two purchases were made in 1986 and 1993. What the economy, interest rates, or the stock market might do in the years immediately following -- 1987 and 1994 -- was of no importance to me in determining the success of those investments. I can't remember what the headlines or pundits were saying at the time. Whatever the chatter, corn would keep growing in Nebraska and students would flock to NYU.

There is one major difference between my two small investments and an investment in stocks. Stocks provide you minute-to-minute valuations for

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your holdings, whereas I have yet to see a quotation for either my farm or the New York real estate.

It should be an enormous advantage for investors in stocks to have those wildly fluctuating valuations placed on their holdings -- and for some investors, it is. After all, if a moody fellow with a farm bordering my property yelled out a price every day to me at which he would either buy my farm or sell me his -- and those prices varied widely over short periods of time depending on his mental state -- how in the world could I be other than benefited by his erratic behavior? If his daily shout-out was ridiculously low, and I had some spare cash, I would buy his farm. If the number he yelled was absurdly high, I could either sell to him or just go on farming.

Owners of stocks, however, too often let the capricious and irrational behavior of their fellow owners cause them to behave irrationally as well. Because there is so much chatter about markets, the economy, interest rates, price behavior of stocks, etc., some investors believe it is important to listen to pundits -- and, worse yet, important to consider acting upon their comments.

Those people who can sit quietly for decades when they own a farm or apartment house too often become frenetic when they are exposed to a stream of stock quotations and accompanying commentators delivering an implied message of "Don't just sit there -- do something." For these investors, liquidity is transformed from the unqualified benefit it should be to a curse.

A "flash crash" or some other extreme market fluctuation can't hurt an investor any more than an erratic and mouthy neighbor can hurt my farm investment. Indeed, tumbling markets can be helpful to the true investor if he has cash available when prices get far out of line with values. A climate of fear is your friend when investing; a euphoric world is your enemy.

During the extraordinary financial panic that occurred late in 2008, I never gave a thought to selling my farm or New York real estate, even though a severe recession was clearly brewing. And if I had owned 100% of a solid business with good long-term prospects, it would have been foolish for me to even consider dumping it. So why would I have sold my stocks that were small participations in wonderful businesses? True, any one of them might eventually disappoint, but as a group they were certain to do well. Could anyone really believe the earth was going to swallow up the incredible productive assets and unlimited human ingenuity existing in America?

When Charlie Munger and I buy stocks -- which we think of as small portions of businesses -- our analysis is very similar to that which we use in buying entire businesses. We first have to decide whether we can sensibly estimate an earnings range for five years out or more. If the answer is yes, we will buy the stock (or business) if it sells at a reasonable price in relation to the bottom boundary of our estimate. If, however, we lack the ability to estimate future earnings -- which is usually the case -- we simply move on to other prospects. In the 54 years we have worked together, we have never forgone an attractive purchase because of the macro or political environment, or the views of other people. In fact, these subjects never come up when we make decisions.

It's vital, however, that we recognize the perimeter of our "circle of competence" and stay well inside of it. Even then, we will make some mistakes, both with stocks and businesses. But they will not be the disasters that occur, for example, when a long-rising market induces purchases that are based on anticipated price behavior and a desire to be where the action is.

Most investors, of course, have not made the study of business prospects a priority in their lives. If wise, they will conclude that they do not know enough about specific businesses to predict their future earning power.

The main danger is that the timid or beginning investor will enter the market at a time of extreme exuberance and then become disillusioned when paper losses occur. (Remember the late Barton Biggs's observation: "A bull market is like sex. It feels best just before it ends.") The antidote to that kind of mistiming is for an investor to accumulate shares over a long period and never sell when the news is bad and stocks are well off their highs.

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If "investors" frenetically bought and sold farmland to one another, neither the yields nor the prices of their crops would be increased. The only consequence of such behavior would be decreases in the overall earnings realized by the farm-owning population because of the substantial costs it would incur to keep switching properties.

And now back to Ben Graham. I learned most of the thoughts in this investment discussion from Ben's book *The Intelligent Investor*, which I bought in 1949. My financial life changed with that purchase.

Before reading Ben's book, I had wandered around the investing landscape, devouring everything written on the subject. Much of what I read fascinated me: I tried my hand at charting and at using market indicia to predict stock movements. I sat in brokerage offices watching the tape roll by, and I listened to commentators. All of this was fun, but I couldn't shake the feeling that I wasn't getting anywhere.

In contrast, Ben's ideas were explained logically in elegant, easy-to-understand prose (without Greek letters or complicated formulas). For me, the key points were laid out in what later editions labeled Chapters 8 and 20. These points guide my investing decisions today.

A couple of interesting sidelights about the book: Later editions included a postscript describing an unnamed investment that was a bonanza for Ben. Ben made the purchase in 1948 when he was writing the first edition and -- brace yourself -- the mystery company was Geico. If Ben had not recognized the special qualities of Geico when it was still in its infancy, my future and Berkshire's would have been far different.

The 1949 edition of the book also recommended a railroad stock that was then selling for $17 and earning about $10 per share. (One of the reasons I admired Ben was that he had the guts to use current examples, leaving himself open to sneers if he stumbled.) In part, that low valuation resulted from an accounting rule of the time that required the railroad to exclude from its reported earnings the substantial retained earnings of affiliates.

The recommended stock was Northern Pacific and its most important affiliate was Chicago, Burlington & Quincy. These railroads are now important parts of BNSF (Burlington Northern Santa Fe), which is today fully owned by Berkshire. When I read the book, Northern Pacific had a market value of about $40 million. Now its successor (having added a great many properties, to be sure) earns that amount every four days.

I can't remember what I paid for that first copy of *The Intelligent Investor*. Whatever the cost, it would underscore the truth of Ben's adage: Price is what you pay; value is what you get. Of all the investments I ever made, buying Ben's book was the best (except for my purchase of two marriage licenses)."

Warren Buffett is the CEO of Berkshire Hathaway. This essay is an edited excerpt from his annual letter to shareholders.

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Raising Financially Responsible Children

Teaching young children the value of money early in life will help them to have a more financially sound future.

1. When should you start teaching children about finances?
This can start as early as when a child learns to count. The following is a very generalized guide for various ages:

AGES FOUR TO EIGHT

- Children gain an understanding that everyone (regardless of income) has a limited amount of money to spend (this is a teachable moment about wants versus needs.)

- Guide them through the process of paying for purchases, like something as simple as paying for a treat at the corner store. Choose a time when the store is not busy so neither the child nor the clerk are rushed.

- Children often receive money for special occasions such as birthdays. Using the basic math principles, children can divide this money into three piles: saving, spending and sharing. This also helps them understand that there are choices to be made and that money spent on one thing means there is less or nothing available to spend on something else. At this age they are also capable of understanding that they may have to wait to buy something they want.

AGES NINE TO 14

- Talk about the difference between needs and wants.

- Build on the concept of saving. Set a goal, say of 10 per cent, and stress the value of having an emergency fund.

- Let them develop a basic savings plan for short term and long term financial goals. The time frames need to be realistic so as not to discourage them from saving, but still teaches them the value.

- Talk about the regular financial commitments families have, such as a monthly mortgage and how you use your income to pay for this.

- Help them create a simple budget for an activity or event – maybe their birthday party.

AGES 15 TO 18

- Understand the concept of living within your means and why this is important.

- Understand the pros and cons of the different payment options such as cash, debit cards and credit cards.

- Understand basic investment options such as a high interest bank account, GICs, savings bonds, and some mutual funds.

2. How do you start at a level they understand?
- Start out easy. With young children (age four or even younger), you can start with the basic concepts of counting and learning the value of different coins and bills.

- As your child grows older, introduce the more complex concepts, including the needs versus wants and income versus expenses.

3. Why is it important for children to know about handling their finances?
- The Financial Consumer Agency of Canada says: Canadians are making financial decisions at younger and younger ages. Grasping financial principles early in life is crucial to being better prepared and avoiding pitfalls in the future.

4. What can parents do to include their children in financial planning for their future?
- Start by talking about money at home when children are around. This helps them to become familiar with financial terms and concepts even at a young age.

- Include them in discussions about family purchases such as new furniture, a car or even a house.

- Consider an allowance. This teaches basic money management skills and promotes good decisions about spending and saving. Parents considering this step should take into consideration the amount they can afford, whether the allowance is given or earned, and be consistent on the day allowance is given so that children learn to plan.

5. Should children learn about budgeting and banking? How?
- Budgeting is an essential skill and can be learned early through involvement in basic family activities, such as planning a family outing. Let children search out the cost of admission, parking, food etc. for an activity. Get them involved in thinking about how to reduce the costs of the outing by taking public transport or a picnic for lunch. Track the savings so children can see the savings, perhaps using a coloured visual like a graph.

- A basic bank savings account is a great way to start children on their path to savings. A bank account also helps children learn about earning interest and expenses such as service fees. This is a good opportunity for children to search out a no-fee banking account and to be able to track their money through their bank statement.

http://www.brantnews.com/news-story/4389761-raising-financially-responsible-children/

Why our 60's are our Glory Decade

In Greek mythology, Eos, the goddess of the dawn, fell in love with Tithonus, a mortal. Eos asked Zeus to make Tithonus immortal but neglected to specify under what conditions. Zeus maliciously granted Tithonus immortality but not eternal youth. Poor Tithonus did not die but instead lived on over countless years, growing ever frailer until he was barely more than a whisper.

Thanks to medical advances and general economic prosperity, life spans are getting longer almost everywhere. At the Living to 100 Symposium in Florida recently, longevity experts predicted that the average person born in developed countries like Canada after 2000 can expect to live to 100, a good 15 years more than current life expectancy. This sounds promising but we should not automatically assume that all our remaining years will be healthy ones.

It is only a matter of time before we succumb to stroke, heart attack, cancer, Parkinson's, dementia or some other age-related illness. It is important to know how many quality years we have left since it affects how we decide to spend our time in retirement.

Eurostat, the European equivalent of Statistics Canada, has compiled some interesting data on average healthy life expectancy for 25 European countries.

The average European woman who is age 50 can expect to live another 34.3 years but a startling 16.2 years of those years will be marred by disability that will moderately limit activity for an average of 10.1 years and severely limit activity in the last 6.1 years.

The story for men is similar, with the average 50-year-old European man expecting to live another 29.4 years of which 12 will be spent with moderate or severe disability. Hence a 50-year-old European can expect to live disability-free to 68 in the case of women and 67 in the case of men.

This is very close to the little Canadian data that is available (from 1997) and suggests that, while there will be many exceptions, our 60s will probably be our last really good decade of life.

So what does this mean for people who are approaching retirement now?

The guiding principle is simple: Do the things you want to do when you can do them. Don't wait too long to take that three-month trip around the world or to finally take some golf or scuba-diving lessons. As for less active things you can do equally well in your 70s, like scrap-booking or gardening, it may make sense to put them off until you get to that age. Your 60s is your glory decade.

As for working in your 60s, you may have no choice financially but if you do have a choice and like your work, then maybe consider working part-time instead of full-time.

This sobering information comes with three pieces of good news.

First, if and when you do succumb to some moderate disability, studies show your spending will decline. Hence, you might afford to spend a little more in your 60s than you thought. It is only in the final few years of severe disability when your spending may trend upwards again (for outside caregivers).

Second, at the same time that life spans are growing, research indicates that the length of time we are disabled is shrinking which means that our disability-free life expectancy is growing faster than our total life expectancy.

As a result, if you are under 50, you can add roughly five or so years to your disability-free life expectancy which will take you well into your 70s. If you are under 35, you can add another five years on top of that so your glory decade will be your 70s.

The final piece of good news is that disability-free life expectancy is something you can improve on. Our approach to health management in our advanced years is changing. Rather than treating each age-related disease as it affects us, a game we can never win, the new emphasis is on regenerative medicine, which involves attacking the aging process itself.

Some gerontologists think we can reach a point in the not-too-distant future when 60-year-olds will enjoy another 30 years of healthy life.

http://business.financialpost.com/2014/02/20/for-rrspwhy-our-60s-are-our-glory-decade/

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Five Money Talks to have with the Family

1. Broach the subject of estate planning with your parents. This is often not the easiest conversation to have. You don't want to seem like you're interfering in your parents' affairs. You don't want to seem like you're counting their money and you also don't want to think about the scary idea that they might not be around.
Be upfront about your fears and start with questions such as: Do you have a will? Do you have a financial advisor that you are speaking to? Have you made any funeral arrangements? Who have you named as an executor of your will?

2. Talk to your adult kids about your estate plans. Assure your children that you've made some preparations and explain your choices. Tell them about your charitable bequeaths. There have been a number of cases in estate planning where children have been upset by the fact that they didn't know that charitable gifts were being made. If there are trusts, help the children understand why they're in place and it's not that you don't trust them with the spending necessarily.
If you have a blended family, an estate plan discussion can avoid future conflict. Those are the ones that end up in challenges and only the lawyers make money in those cases.

3. Raise the issue of capacity. Have your loved ones ever given thought to what will happen if they ever become physically or mentally disabled and are not able to make medical or financial decisions? Ask if they have powers of attorney in place. If something happens and it's hard for you to take care of yourself, what is quality of life to you? Do you want to remain in your home or do you want to go somewhere else? These are important conversations to have and they're easier to have before you're in a crisis.

4. Discuss debt. If you have a child or a family member or a sibling in financial trouble, the instinct is to help them pay things off. That can be problematic. Sometimes you can enable the problem if you just keep giving money; but if you try to preach to them…that can be very difficult too. Try not to be judgmental and tell your loved one that your intention is to help them. Bring in an independent advisor might neutralize the situation.

5. Talk about your money values. What values were passed onto you from your parents and your grandparents? How have you dealt with money in your past? There's a lot of history that doesn't get passed on to children. You are passing along values that people can think about and they don't feel like they're being preached to — they're just hearing a good story.

http://business.financialpost.com/2014/02/15/weekendfive-money-talks-to-have-with-the-family-this-weekend/

Health and Wellness: The Juicing Craze

Juicing has taken the health world by storm, and millions of people are now gulping down pounds of produce by the glassful. A swarm of celebs including Salma Hayek, Alicia Silverstone, and Megan Fox have jumped on the juicy bandwagon for its convenient approach to clean eating. Other proponents include Ryan Seacrest, who sips on an earthy blend of collard greens, kale, broccoli, coconut water and green tea, and Gwyneth Paltrow, who's been known to kick off the New Year with a week-long liquid detox. But does this thirst-quenching trend truly promote health or is it just hype? Like most Hollywood fads, these fashionable beverages have their pros and cons.

Here's What You Should Know
First, the benefits. Juicing is an easy way to shower your body with concentrated amounts of nutrient-packed vegetables and fruit. Plus, these drinks are automatically low in ingredients you want to avoid, like toxic fats, added sugars and salt. For this, they receive an A+.

Now, the downsides. If you're considering a juice fast to drop pounds fast, listen up. While strictly following a juicing program for more than a few days can promote a downward trend on the scale because you're slashing your collective daily calories, you pay a price: Most plans leave gaping nutritional holes in your diet. The majority of the calories in these juice beverages come from carbs, including high amounts of natural sugar from fruits and some vegetables. That means almost all commercial juice plans are grossly inadequate in protein, a key nutrient that helps you feel full and energized while maintaining your lean muscle mass and boosting your metabolic burn. In fact, following a *low-protein diet* while simultaneously cutting calories causes you to lose a higher proportion of weight as muscle tissue (as opposed to fat), which puts the brakes on your metabolism and reduces strength. Plus, most of the fiber in fruits and vegetables is lost during juicing if the pulp is not added back to the drink… a common issue with commercial juice blends on the market. So you're basically following a high-carb, low-protein and low-fiber diet, which can cause dramatic spikes in blood sugar, and lead to headaches, mood swings, dizziness, and fatigue. Another major drawback: liquid calories do not have the same fill power as whole, solid foods, which makes it hard to stick with a juice-only plan for longer than a few days without feeling irritable and completely ravenous.

http://www.joybauer.com/healthy-living/the-juicing-craze-health-or-hype.aspx

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Spring Activities

The Cottage and Backyard Show
April 11th – 13th
http://www.caneastshows.com/

The Baby Show
May 3rd – 4th
http://thebabyshows.com/

The Tulip Festival
May 9th – 19th
http://tulipfestival.ca/

Ottawa Race Weekend
May 24th – 25th
http://www.runottawa.ca/

The Dragonboat Race
June 21st – 24th
http://www.dragonboat.net/

The Ottawa Jazz Festival
June 20th – July 1st
http://ottawajazzfestival.com/

Upcoming Events

- Evening Seminar
  Seasonal Gardening with Neil Ritchie
  April 2014, TBD

- Evening Seminar
  Investment Metrics with Duane Francis and Michael Prittie
  May 2014, TBD

- Family Movie Day
  Family Movie Day
  June 2014, TBD

- **The "Let's Take a Swing at Cancer" Golf Tournament**
  June 3rd, 2014

Canada Day Festival

On July 1, join us in Ottawa–Gatineau to celebrate Canada's birthday!

Canada's Capital Region buzzes with activity, as Canadians from across the country flock to the Capital to show their national pride.

The festivities take place on Parliament Hill, in downtown parks and on the streets. Witness the ceremonies, take in the musical talent from across the country, and see the fireworks— and more!