THE TEMPTATION OF ST. WARREN

By Michael Lewis

"I have never known much good done by those who affected to trade for the public good." —Adam Smith

I still remember the marvelous frisson on the Salomon Brothers trading floor in the summer of 1987 when Warren Buffett came riding in from Omaha to rescue our chairman, John Gutfreund, from his past. In an era in which money men found a seemingly unlimited number of financial temptations to succumb to, Buffett was the sort of ascetic rarely seen on Wall Street. He had made his name and his money the old-fashioned way, as a long-term investor in wealth-creating American enterprise. His angry sermons aimed at modern financial techniques had established him as one of the more acceptable faces of American capitalism. In his two-toned world there were good people who were useful to society, bad people who weren't, and not much room in between for the sort of charming rogues he was about to embrace. "If you want to make money," he was fond of telling business school students, "hold your nose and go to Wall Street."

Suddenly there was a delicious gap between what the moralist said and what he did. The annual reports of Buffett's investment firm Berkshire Hathaway had treated leveraged buyouts to a long critique as harshly skeptical as any ever published; Salomon Brothers masterminded several of the more sensational leveraged buyout disasters of the time, including those of Revco and the Southland Corporation. Salomon Brothers also peddled billions of dollars of ill-fated junk bonds; of the junk bond market Buffett wrote in an annual report that "as usual, the Street's enthusiasm for an idea was proportional not to its merit, but rather to the revenue it would produce. Mountains of junk bonds were sold by those who didn't care to those who didn't think." The Salomon Brothers trading floor throbbed with speculation; Buffett often lamented the cost to the U.S. economy of "casino-type markets." "To many on Wall Street," he wrote, "both companies and stocks are seen only as raw materials for trades." His pet solution to the problem—a 100 percent tax on short-term capital gains—would have closed overnight half an acre of the Salomon trading floor. Not that the prospect would have troubled Buffett, who was contemptuous of even the more legitimate activity of brokerage houses. "I never talk to brokers or analysts," he told Linda Grant of *The Los Angeles Times*. "Wall Street is the only place that people ride to in a Rolls Royce to get advice from those who take the subway."

Salomon Brothers stood for most of the things Buffett stood against, above all in its management's disregard for its shareholders. The firm's share price had fallen through a bull market; civil war raged on the trading floor; top employees regularly defected to other firms. There was talk in the ranks of ousting Gutfreund from within. And now—the reason for Buffett's appearance on the scene—corporate raider Ronald Perelman was making a hostile bid for the company. The many challenges to Gutfreund's authority ended with the arrival of Buffett's money. "We've got a commitment to vote with John," Buffett told *The New York Times* in September 1987, "and we hope he stays there a long, long time."

For $700 million and a job guarantee for Gutfreund, Buffett was given a security that combined the juicy bits of a stock and a bond. It guaranteed him a return of 9 percent a year, established him as the controlling shareholder of Salomon Brothers, and left him with about the same opportunity for huge gain as the ordinary shareholder—without the risks. Auctioned on the open market, the $700 million convertible preferred would have fetched anywhere from $850 million to $1.2 billion. His windfall came out of the shareholders' pockets, since his cheap option dilutes the value of the existing shares. Although a few of them sued, the deal never met the popular resistance it deserved, mainly because it involved Buffett. Public feeling was that if it was wrong, Buffett would never have done it; therefore it must have been right.

In effect the moralist had sold his reputation, without pausing to measure the man willing to pay such a price for it. Perhaps heartened by the critical success of the first foray, Buffett quickly made the business of saving CEOs from corporate predators a rule rather than an exception in his portfolio. He cut about $1.2 billion more of similar sweet, off-market deals with the chief executives of U.S. Air, Champion, and Gillette. Around the same time he became involved in

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other business he might be expected to avoid or even to denounce, given his views on modern financial excess. In the middle of 1988 he broke with his strict rule of long-term investing and became an arbitrageur, which is to say he speculated on pending takeovers. The next year he made a convenient exception to his fierce disapproval of leveraged buyouts and offered financial backing to the most notorious team—that of Ross Johnson—aiming to borrow $25 billion for a buyout of RJR Nabisco. In 1990 he built a large stake in the junk bonds of the newly leveraged RJR Nabisco (which, as George Anders describes in his forthcoming book, *Merchants of Debt,* was so badly constructed that one year after its transformation it very nearly became the largest bankruptcy in history).

Of course there was nothing illegal about any of this; it was even ethical to some people's way of thinking. The trouble is that Buffett wasn't one of those people. But rather than simply acknowledge that he had been forced to bow to the two central facts of modern financial life—that a lot of profitable financial business was of dubious social value, and that a money manager wishing to attract funds could ill afford to shun profitable deals—Buffett continued to defend his moral turf. While bashing Wall Street in the abstract, he praised in the concrete whatever happened to drift into his portfolio. Thus, in the Berkshire annual reports, Gutfreund became a man of the highest integrity, RJR Nabisco an unusually sound leveraged buyout, and arbitrage trading a good, solid business. This is not to suggest that Buffett was insincere. He was very sincere. He clearly wanted to believe the hoary myth he helped to perpetuate—that success and virtue are the same thing. But because they weren't, he spent his 1980s backing slowly and charmingly into a corner.

WARREN BUFFETT BY VINT LAWRENCE FOR THE NEW REPUBLIC

Buffett's dilemma is partly a function of his own financial biography. Between 1977 and 1991 Berkshire Hathaway grew from a medium-sized pool of $180 million to one of more than $11 billion in risk capital. With this success came the new problem of where to put the money to work. About the same time Buffett seemed to become frustrated with the lack of opportunity in the stock market. "In the '70s I had a lot of ideas and very little money," he told *The New York Times* in 1990. "Now I've got a lot of money and very few ideas." He explained to his shareholders each year that the investment climate was less friendly than the last and asked them not to expect their money to grow at the 23 percent annual rate he had achieved over the previous twenty-one years. He even once suggested, in 1985, that his bogey was merely to outstrip the average returns of corporate America.

This modesty is inconsistent with Buffett's vanity about his reputation as an investment genius. The main threat to this reputation—other than his performance, which has lagged the market during the past two years—is the strong academic evidence that success in the stock market is no different from success in a coin-flipping contest. The suggestion that he is merely lucky drives Buffett to distraction. He regularly ridicules skeptical professors with a vaguely thuggish if-you're-so-smart-why-am-I-rich routine. (The reason he is rich is simply that random games produce big winners, but pity the business school professor on fifty grand a year who tries to argue with a billionaire.) While his little rhetorical victories may offer him short-term consolation, they also reveal the enormous pressure on Buffett to vindicate his precarious perception of himself.

As his fund grows Buffett is in the position of the roulette player who has amassed a great number of chips, a swarm of blond and buxom admirers, and finds himself with all the bets on the board—he can't beat the average because increasingly he *is* the average. This helps to explain the drift in his investment strategy away from the sort of long-term investments anyone can make to those available only to the privileged

few—the very few he still disparages. He has gone to the casino owner, flashed a fat wallet, and cut a special deal. That he is only pretending to play the same game as the rest of us should make us suspicious of his more general pronouncements about the game.

The volume of demand for the Berkshire Hathaway reports has led the company to bind into two volumes the Buffett letters, 1977-1990. They are the modern equivalent of *Poor Richard's Almanac*, in both their spirit and their artfulness. The tone of the earlier reports is so different from that of the later reports that they might be the work of different people. In 1977 Buffett assumes his usual position that business is more than the unbridled pursuit of profit:

> A few shareholders have questioned the wisdom of remaining in the textile business which, over the longer term, is unlikely to produce returns on capital comparable to those available in many other businesses. Our reasons (for hanging tough) are several. 1) Our mills both in New Bedford and Manchester are among the largest employers in each town, utilizing a labor force of high average age possessing relatively non-transferable skills. Our workers and unions have exhibited unusual understanding and effort in cooperating with management to achieve a cost structure and product mix which might allow us to maintain a viable operation. 2) Management also has been energetic and straightforward in its approach to our textile problems ... 3) With hard work and some imagination regarding manufacturing and marketing configurations, it seems reasonable that at least modest profits in the textile division can be achieved in the future.

As his business becomes more slick and complex the reports grow more cloyingly earthy and honest. Buffett first assumes the tone of the philosopher-preacher in the early 1980s. By 1982 it is clear that he is the man rocking on his front porch playing to a gathering crowd, quoting everything from scripture to Samuel Goldwyn. In 1983 he begins to devote space to morally instructive businesses out of all proportion to their importance to Berkshire Hathaway's portfolio, in this case the stick-to-the-knitting virtues of "Mrs. B," the ninetysomething manager of the Nebraska Furniture Mart. In 1985, before announcing the closure of the above-mentioned textile mills, he got in a good joke or two about investment professionals. In 1986 he explains that he has switched to the new Cherry Coke as the official drink of the Berkshire annual meeting in Omaha. The next year he begins seriously to inveigh about the speculative excesses of Wall Street. And he has never stopped.

It has worked. The corrosion of Buffett by the demands of the market has been largely masked by his moralistic charm. The legend of the virtuous Midwesterner made good has been swallowed and regurgitated whole and often. Nowhere has there been any serious discussion of the shift in what Buffett actually does for his money. Some of the reasons for this are fairly transparent: the awe of journalists in the presence of a man worth $4 billion who is also obviously a nice man; the nostalgia for an earlier, simpler age of American capitalism; the need to buttress the belief that success isn't necessarily corrupting; the tendency of the business press to glorify mindlessly, on the assumption that mindless glorification is harmless.

But there is another reason: Buffett's media touch, which doesn't get nearly as much play as it deserves. He spends a lot of time talking to journalists off the record, and avoids turning up in the flesh in the many profiles of his person. A lot of people will even tell you that he is simply too busy to bother with his image. They should consider his recent battle with *The Wall Street Journal*, which dared to print a few facts inconsistent with the Buffett myth—that he keeps a mistress, hobnobs with celebrities, and enjoys his luxuries (fancy threads, limos, suites in the Plaza) as much as any billionaire.

The piece elicited a series of angry private letters from Buffett to the editors, and a single, fascinating correction. *Journal* reporter Laurie Cohen had mentioned in a sidebar that, soon after taking control of Salomon Brothers, Buffett had called his close friend James Burke, the former head of Johnson & Johnson. According to the *Journal*, Burke, who had weathered the Tylenol scandal, advised Buffett to "be contrite and honest. And tell the public and regulators about the mistakes—no matter how bad—as quickly as you can." It's hard to imagine anyone being upset about it being known he had given such sound, obvious advice. Yet six days later the *Journal* was forced to print an oddly hysterical letter from Burke, in which he said he "was appalled to read ... the opening paragraphs of your Nov. 8th story." According to him the conversation described had never taken place. Having failed to confirm the anecdote with Burke, the *Journal* was forced to apologize.

What was fascinating is that the anecdote had been told to eight *Journal* reporters in an off-the-record session by ... Warren Buffett. The effect of the retraction, as pointed out by the *Business News Reporter* (to which *Journal* staffers leaked the source), was to discredit the piece on the grounds of shoddy reporting. "Imagine," wrote Thomas K. Grose in the *News Reporter*, "the bitterness of the nation's most respected business daily having to confess that it quoted someone whom it never actually spoke with. Moreover the paper knows that either Mr. Buffett or Mr. Burke is not telling the truth, but has no way of letting its readers know that without violating the paper's confidentiality pledge to Mr. Buffett. If someone had plotted to manipulate the paper into such a no-win situation, it is doubtful that the sting could have been executed as well."

Among the consequences of the gentling of Warren Buffett is the current spectacle at Salomon Brothers. Last August the firm acknowledged that one of its traders had, by using fictive customer orders, broken the bidding rules in eight U.S. Treasury bond auctions. It turned out that Gutfreund had sat on this news for four months before an encroaching investigation forced his hand. In the subsequent public outrage there was a moment

when it appeared that there might be a serious discussion in Congress and the Treasury about the conflicts of interest on a Wall Street trading floor. That ended when Buffett forced Gutfreund to resign and replaced him at the top of Salomon. From that moment it was assumed that with a man of integrity on the scene the business would pretty much reform itself. Ohio Representative Dennis Eckart spoke for his congressional colleagues when, in a hearing on the scandal, he said, "Mr. Buffett ... get in there and kick some butt." No one seemed to notice that he had been in there all along—that the managers responsible for the transgressions held their jobs only because Buffett put his good name behind them four years earlier.

Buffett's view now seems to be that the problems on Wall Street can be resolved by setting a moral example. The subtext of everything he has done is that the old Salomon was run by rotten apples. The firm very publicly cut long-standing ties to the oil trading tax fugitive Marc Rich. Buffett laid blame for the rule-breaking on the "macho culture" of the old Salomon Brothers and said that his new regime would tolerate incompetence but not impropriety. All of which played a bit too neatly to the current need to demonize financiers—and raised the question of why tax fugitives and testosterone freaks didn't much bother Buffett before the scandal.

Still, in the short run he is probably right. You can frighten people into behaving themselves for a while. But in the long run he's wrong. The financial revolution of the last decade introduced to Wall Street all sorts of temptations to abuse one's position. When socially unproductive behavior pays as well as it has, it isn't merely a matter of needing a few more good men. The dirty little secret on Wall Street is that the men responsible for its current reputation were not exceptionally bad. They were just ordinary people placed in unusual circumstances.

The cult of the investment genius promoted by Buffett is part of the problem, and has real social costs. The belief that there is such a thing as stockpicking expertise helps financial charlatans everywhere to flourish and leads investors to assume unnecessary market risks. It underpins the entire American investment advisory industry; without it an enormous amount of wasteful machinery—which Buffett himself knows to be wasteful—would collapse. People listen to stockbrokers, subscribe to newsletters, attend floating investment conferences, glue themselves to Financial News Network until the wee hours, read the fine print of *The Wall Street Journal*, and generally expend a fantastic amount of time and energy picking stocks in the mistaken belief that they can beat the market systematically. If one is looking for the root cause of the hysterical swings in the public mood toward Wall Street, one need go no further: they simply reflect the irrational expectations of the investment public.

What is really needed on Wall Street is not more "investment geniuses" or good men like Buffett but a reduction in the conflicts of interest to which financial people are exposed. There are ways to lessen the temptations in modern finance, but not without cutting into profits. I offer two examples. First: the takeover boom created a boom in extremely valuable inside information. Wall Street firms, which create and house this information, are also permitted to speculate in the relevant corporate stocks. Why? If Buffett were really interested in reforming Salomon Brothers, he would start by closing the arbitrage department. Second: firms like Salomon both buy bonds for their own account and sell them to investors. This inherent conflict of interest did not matter very much in the placid pre-Reagan bond markets partly because there was very little trading in the markets but also because bond salesmen tended to service the same set of investors for years and thus had an interest in keeping the customer happy. Now it matters very much. The new American taste for debt over the last ten years created a truly fantastic increase in both the size and complexity of the bond market; at the same time market forces and the new mobility of Wall Street salesmen transformed the bond business from one of relationships to one of transactions. This creates both the incentive and the opportunity to shaft the customer. Indeed, the abuse of customer names made the Salomon Treasury bond scam possible. So why not address this problem with, say, a proposal to separate bond trading from bond sales?

Thus we arrive at what might be called Buffett's Dilemma: the choice between doing good and making money. The source of a lot of the behavior that Buffett says he will no longer tolerate—the Salomon bond trading departments—also happens to generate the profits. Everything Buffett has done has strengthened their hands. He fired the head of the stock department, who was about as far removed from the scandal as a person can be. He installed a new board of directors consisting of nine mostly bond men already at or near the top, i.e., the elect of the old Salomon. He linked year-end bonuses more closely to the amount of money generated for the firm. He fired a lot of people outside of the bond departments, a hugely disproportionate number of whom were women—not exactly the way to geld the macho bull.

Though all of this will likely increase returns for shareholders and Buffett, it fails to address the real systematic problems. But is that so surprising when the reform of a business has been left to a man with a huge financial stake in it? One can sympathize with the fix in which Buffett finds himself. One cannot blame him for doing whatever is necessary to protect his $700 million. But it is absurd to cast his activity as a moral crusade. You'd have thought that our recent experience would have cured us forever of the idea of financiers as heroes—that their new, alarming tendency to drift into compromising positions would inspire in the republic only the urge to keep them under constant surveillance. Guess what? It hasn't. •