

The background of the cover features a series of concentric circles in a light gray color, centered on the left side. The word "INVESTING" is written in a large, bold, red, sans-serif font, with the "I" and "N" partially overlapping the circles.

CONCENTRATED INVESTING

STRATEGIES OF THE WORLD'S GREATEST
CONCENTRATED VALUE INVESTORS

A smaller version of the concentric circles graphic is located behind the authors' names.

ALLEN C. BENELLO • MICHAEL VAN BIEMA
TOBIAS E. CARLISLE

WILEY

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Preface

Michael and I came up with the idea for this book while riding in a taxi on the way to a meeting with an investment manager. Michael interviews managers of value oriented funds regularly for his fund of funds business, and has met with at least a few hundred during the course of his career. On this particular occasion Michael asked me to come along to help evaluate a new manager, and I agreed to join him in between meetings of my own. As unlikely a place as it was to hatch the inspiration for this project, we were both puzzled by a strange paradox that we had observed over many years in the investment business: The returns generated by investors do not always correlate to their ability to analyze and understand companies.

With the initial idea for a book, and a set of interviews, Michael and I reached out to Bill Falloon at Wiley for help. Bill introduced Michael and me to Tobias Carlisle, the author of two other successful investment books, “Quantitative Value” and “Deep Value.” We found that they shared a very similar set of ideas about investing in general and about the theme for the book, concentrated investing, in particular. We hit it off immediately. Tobias agreed to come on board as a coauthor along with Michael and me. He has been instrumental in helping to take the raw interviews and put the investors and their flagship investments into their proper historical and theoretical context. He also helped to examine the strategy quantitatively to determine the drivers of outperformance: Was it a matter of selecting the *right* securities, or holding them in the *right* amounts?

I recall one individual, whom we’ll call Investor Number One, whose returns were decent, but who seemed to be totally off-base when it came to the highly subjective and trickier job of figuring out whether a company’s business and management were fundamentally attractive, or worth skipping over. He had made some notable blunders, on one occasion pounding the table to his colleagues about a soft goods company that was soon destined for bankruptcy. To me and a few others with whom I spoke at the time, it wasn’t difficult to comprehend that this company was not attractive and perhaps even precariously situated, so it left me scratching my head when I read his fund’s performance results, which seemed to have a way of levitating away from what must have been some costly errors.

On the other hand, another acquaintance whom we will call Investor Number Two was deeply insightful when discussing an industry or company and always grasped the investment case, for or against, with enviable precision and knowledge of the relevant facts. This second person's returns, however, were decidedly lackluster. He somehow never managed to fully capitalize on his insights, which were tremendously valuable and, one would have thought, should have led to very outstanding returns.

This paradox got us thinking about the topics of security analysis and portfolio construction, and how they relate to returns. Apparently, analytical ability alone does not constitute a really good investor. Investor Number Two in the preceding example should have been doing better with his ideas, and just imagine what Investor Number One could have accomplished if he had been more analytically competent.

A lightbulb turned on when I realized the investors I admire the most (and this admiration comes only in part from the amazing success they've achieved) tend to share one characteristic: They are concentrated value investors. That is, they adhere to a concentrated approach to portfolio construction, holding a small number of securities as opposed to a broadly diversified portfolio. We set out to study the mathematical and statistical research that has been done by various academics on the subject of portfolio concentration, and to chronicle the methods and achievements of some of the people who have benefited from being concentrated value investors. Our first task was to approach Lou Simpson and Kristian Siem, two ultra-successful concentrated value investors who had never previously agreed to interviews on the mechanics of their investment style. As we completed their interviews, we began to compile material on the subject of portfolio concentration, a trail that ultimately reached back beyond the Kelly Formula to John Maynard Keynes.

In *Concentrated Investing: Strategies of the World's Greatest Concentrated Value Investors*, we examine some of the methods these extraordinary individuals employ, providing the reader an insight into how they function and how they have managed to accomplish their returns. However, two very important caveats are necessary. First, concentrated investing is not for everyone. As Glenn Greenberg said, Peter Lynch (manager of the Fidelity Magellan Fund during its most successful period, earning truly amazing average annual returns during his tenure) was anything but a concentrated investor, owning a large number of securities in the fund. Furthermore, concentrated investing should only be undertaken by people who are prepared to do intensive research and analysis on their investments. People outside of the investment profession usually don't have the time to do this, and are far better off with an index fund or finding a competent investment manager—preferably one who employs a focused approach.

The second caveat is more important, and applies to investment professionals and non-professionals alike (perhaps even more to professionals). It is summed up in an insightful and humbling quote from legendary martial artist Bruce Lee, which is as follows:

A goal is not always meant to be reached, it often serves simply as something to aim at.

Coming from one of the most disciplined and exacting athletes in the history of martial arts, this statement is illuminating. One can hardly imagine Bruce Lee trying to break a two-by-four with his fist and accepting, after a failed attempt, that this goal was not reachable. Evidently, beneath his hard-driving exterior, there was a more philosophical side. Similarly, in the context of this book, our intention is not to show that the great individuals profiled in the following chapters constitute the standard against which one should hold oneself, but to provide a road map with some concrete ideas on how to be a better investor. Not everyone should attempt to replicate their style or accomplishments. Rather, these profiles are a guidepost on the journey to successful investing.

With these caveats, we do believe that the average enterprising investor with the ability to perform in-depth fundamental analysis will be better off trimming the number of investments they hold and redistributing their capital into their top 10 or 15 ideas. To quote Bruce Lee a second time:

The successful warrior is the average man, with laser-like focus.

—Allen Carpé Benello

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Introduction

Concentrated Investing

Conscientious employment, and a very good mind, will outperform a brilliant mind that doesn't know its own limits.

—Charlie Munger¹

Concentration value investing is a little-known method of portfolio construction used by famous value investors Warren Buffett, Charlie Munger, long-time Berkshire Hathaway lieutenant Lou Simpson, and others profiled in this book to generate outsized returns. A controversial subject, the idea of portfolio concentration has been championed by Buffett and Munger for years, although it moves in and out of fashion with rising and falling markets. When times are good, portfolio concentration is popular because it magnifies gains; when times are bad, it's often abandoned—after the fact—because it magnifies volatility. Concentration has been out of favor since 2008, when investment managers began in earnest to avoid what they perceive as a risky business practice.

It is time to re-visit the subject of bet sizing and portfolio concentration as a means to achieve superior long-term investment results. We will start by examining some of the academic research on concentration versus diversification on long-term investment results. One central feature of the discussion surrounding concentration is the Kelly Formula, which provides a mathematical framework for maximizing returns by calculating the position size for a given investment within a portfolio using probability (i.e., the chance of winning versus losing) and risk versus reward (i.e., the potential gain versus the potential loss) as variables. The Holy Grail for any investor is a security with a high probability of winning and also a large potential gain compared to the potential loss. Given favorable inputs, the Kelly Formula can produce surprisingly large position sizes, far larger than the typical position size found in mutual funds or other actively managed investment

products. In addition, some academic studies point to the diminishing advantages of portfolio diversification above a surprisingly small number of individual investments, provided each investment is adequately diversified (no overlapping industries, etc.). Also, portfolios with a relatively smaller number of securities (10 to 15) will produce results that vary greatly from the results of a given broadly diversified index. To the extent that investors seek to outperform an index, smaller portfolios can facilitate that goal, although concentration can be a double-edged sword.

Investors can employ the traditional value investing methodology of fundamental security analysis to identify potential investments with favorable Kelly Formula inputs (a high probability of winning, and a high risk/reward relationship), in order to maximize the chances of significant outperformance, as opposed to significant underperformance, with a concentrated portfolio.

We have unparalleled access to investors in Warren Buffett's inner circle. Interviews with several highly successful investors who have achieved their success employing a concentrated approach to portfolio management over the long term (at least 10 to 30 years) will be incorporated throughout this book. One common feature of these investors is that they have had permanent sources of capital, which has changed their behavior by allowing them to endure greater volatility in their returns. Most people seek to avoid volatility in general because they perceive increased variance as an increase in risk. The investors we examine, however, tend to be variance seekers. At the same time, however, they are able to produce returns with low downside volatility compared to the underlying markets in which they invest.

This book profiles eight investors with differing takes on the concentration investment style. The investors and the endowment interviewed are contemporary. One of the investors profiled, Maynard Keynes, is now a historical figure, but was the early adopter of many of the ideas that came to be held by his successors. The purpose of the book is to tease out the principles that have resulted in their remarkable returns. Though they operated through different periods of time, all have compounded their portfolios in the mid-to-high teens over very long periods—defined as more than 20 years. The investors in this book are rare in that they all have either permanent or semi-permanent sources of capital. We hypothesize that this is an important factor in allowing them to practice their focused style of investment. The book also puts forward a mathematical framework, the Kelly Criterion, for sizing investment “bets” within a portfolio. The conclusion of both the profiles of these great investors and of the Kelly Criterion is remarkably coincident.

Modern portfolio theory would have us believe that markets are efficient and that attempts to beat market performance are both foolhardy and expensive in terms of return. Yet the fact remains that there is at least a small cadre of active managers who have beaten the market by a significant

margin over prolonged periods. This book and the investors profiled in it agree with the proponents of efficient market theory on two points:

1. Markets are mostly efficient.
2. They should be treated as efficient if you are, as Charlie Munger puts it, a “know-nothing” investor.

In other words, it requires a lot of hard work and a significant amount of knowledge to produce market-beating returns. If you do not have this, it is to your benefit to diversify and index. If, however, you possess knowledge and the capability for hard work as well as a few other characteristics outlined in the book, it is to your benefit to focus your energies on a small number of investments. The degree of focus is a stylistic choice and cannot be prescribed for any given individual, but the investors in this book concentrate on anywhere from 5 to 20 individual securities. The larger the number, the more the benefits of diversification, the lower the volatility of the portfolio, but also, in most cases, the lower the long-term returns. The trade-off between larger bets and more volatility is an individual choice, but both the Kelly Formula and the participants in the book point to the advantages of larger bets and more concentrated portfolios. In fact, the reader will probably be quite surprised by how large the bets can be calculated to be. Once again, placing bets of significant size depends on appropriately skewed probabilities, and these types of probabilities are uncommon, but both the mathematics and the investors argue for large bets when situations with unusual risk/return arise. It is important to note that the risk referred to here is the risk of permanent loss of capital and not the more commonly used academic metric of volatility. The investors in this book are willing to suffer through periods of temporary (but significant) loss of capital in an attempt to find opportunities where the probability of the permanent loss of capital is small. In other words, they attempt to find situations that offer a strong margin of safety where one's principal is protected either by assets or by a strong franchise and an unlevered balance sheet.

The investors in this book come from very different backgrounds ranging from an English major to an economist, but somehow they ended up in quite similar places in terms of their general investment philosophy. The singular trait that unites these investors, and separates this group from the herd of investors who try their luck on the stock market is temperament. Asked in 2011 whether intelligence or discipline was more important for successful investors, Buffett responded that temperament is key:²

The good news I can tell you is that to be a great investor you don't have to have a terrific IQ. If you've got 160 IQ, sell 30 points to

somebody else because you won't need it in investing. What you do need is the right temperament. You need to be able to detach yourself from the views of others or the opinions of others.

You need to be able to look at the facts about a business, about an industry, and evaluate a business unaffected by what other people think. That is very difficult for most people. Most people have, sometimes, a herd mentality, which can, under certain circumstances, develop into delusional behavior. You saw that in the Internet craze and so on.

...

The ones that have the edge are the ones who really have the temperament to look at a business, look at an industry and not care what the person next to them thinks about it, not care what they read about it in the newspaper, not care what they hear about it on the television, not listen to people who say, "This is going to happen," or, "That's going to happen." You have to come to your own conclusions, and you have to do it based on facts that are available. If you don't have enough facts to reach a conclusion, you forget it. You go on to the next one. You have to also have the willingness to walk away from things that other people think are very simple. A lot of people don't have that. I don't know why it is. I've been asked a lot of times whether that was something that you're born with or something you learn. I'm not sure I know the answer. Temperament's important.

Munger says of Buffett's theory:³

He's being extreme of course; the IQ points are helpful. He's right in the sense that you can't [teach] temperament. Conscientious employment, and a very good mind, will outperform a brilliant mind that doesn't know its own limits.

In the next chapter we meet Lou Simpson, the man Warren Buffett has described as "one of the investment greats."⁴

NOTES

1. Charles Munger, interview, February 23, 2012.
2. "A Class Apart: Warren Buffett and B-School Students," NDTV, May 24, 2011, <https://www.youtube.com/watch?v=4xinbuOPt7c>, as discussed in Shane Parrish, "What Makes Warren Buffett a Great Investor? Intelligence or Discipline?" *Farnam Street Blog*, April 19, 2014.
3. Charles Munger, interview, February 23, 2012.
4. Warren Buffett, "Chairman's Letter," Berkshire Hathaway, Inc., 2010.

Lou Simpson: The Disciplined Investor

A Portrait of Concentration

Stop the music.

—Warren Buffett to Jack Byrne, chairman of GEICO,
after meeting Lou Simpson in 1979¹

In 1979, GEICO, an auto insurance company based in Washington, DC, that had been brought close to bankruptcy just three years earlier was searching for a new chief investment officer. The company's recent near-death experience, and the perception of insurance companies' investment efforts as hidebound, and highly risk-averse, had made the search difficult. The recruiter, Lee Getz, vice chairman of Russell Reynolds, did find a candidate who later turned it down because his wife refused to move to Washington.² Lamenting his lack of success in filling the position in over a year, Getz told his friend Lou Simpson about the little insurance company with big problems that no one wanted to tackle. He asked Simpson, the chief executive of California-based investment firm Western Asset Management, if he was interested in the job. Simpson was reluctant.³ Western Asset Management had been a subsidiary of a big California bank holding company. Simpson was sick of politicking within the confines of bank bureaucracy, and didn't have any great desire to repeat the experience in an insurance company. He also knew that GEICO had almost gone belly up just three years earlier.

As a favor, Getz asked Simpson to interview with the company's chairman, John "Jack" Byrne Jr., the man who had almost single-handedly pulled GEICO back from the brink of insolvency.⁴ Simpson agreed if only to help out an old

friend. He traveled to Washington to meet with Byrne, who Simpson judged as being “a very, very smart guy,” but also a micro-manager involved in everything GEICO did.⁵ Simpson found the role interesting, but not compelling. He craved autonomy, and Byrne, who had just saved GEICO, seemed unlikely to grant it. Byrne called Simpson back for a second interview. Though he had reservations he dutifully traveled back to Washington. In the second interview, Byrne told Simpson, “We’re really interested in you. But the one hoop you’re going to have to go through is to meet with Warren Buffett.”⁶ With about 20 percent of GEICO, Buffett was the largest shareholder through Berkshire Hathaway. Byrne said, “Warren thinks we need a new investment person. The person before was really not up to the job.”⁷ Though Buffett didn’t yet have a high profile, Simpson had read about the Nebraska-based value investor who was just renewing a longstanding interest in GEICO.

“UNSTOPPABLE” GEICO

Buffett has a storied 65-year association with GEICO, beginning in 1951 as a 20-year-old graduate student in Benjamin Graham’s value investing class at Columbia. He recounted the first 45 years of that association in his 1995 Chairman’s Letter following Berkshire’s purchase of the half of GEICO it didn’t own.⁸ It was then the seventh-largest auto insurer in the United States, with about 3.7 million cars insured (in 2015, it is second, with 12 million policies in force). Buffett attended Columbia University’s graduate business school between 1950 and 1951 because he wanted to study under Graham, the great value investor and investment philosopher, who was a professor there. Seeking to learn all he could about his hero, he found that Graham was the chairman of *Government Employees Insurance Company*, to Buffett “an unknown company in an unfamiliar industry.”⁹ A librarian referred him to *Best’s Fire and Casualty* insurance manual—a large compendium of insurers—where he learned that GEICO was based in Washington, DC.

On a Saturday in January 1951, Buffett took the early train to Washington and headed for GEICO’s downtown headquarters. The building was closed for the weekend, but he frantically pounded on the door until a custodian appeared. He asked the puzzled janitor if there was anyone in the office the young Buffett could talk to. The man said he’d seen one man working on the sixth floor—Lorimer Davidson, assistant to the president and founder, Leo Goodwin, Sr. Buffett knocked on his door and introduced himself. Davidson, a former investment banker who had led a round of funding for GEICO before joining it, spent the afternoon describing to Buffett the intricacies of the insurance industry and the factors that help one insurer succeed over the others.¹⁰

Davidson taught Buffett that GEICO was the very model of an insurer built to succeed. Formed in 1936, at the height of the Great Depression by Goodwin and his wife Lillian, GEICO was set up to be low-cost from the get go.¹¹ Goodwin had been an executive at the United Services Automobile Association (USAA), an auto insurer founded to insure military personnel, and a pioneer in the direct marketing of insurance. He had seen data that showed federal government employees and enlisted military officers tended to be financially stable, and also low-risk drivers. Those two attributes, he surmised, would mean that premiums were paid on time, with lower and infrequent claims. Agents were typically used to provide professional advice for more complex business insurance requirements. Auto insurance, though it was mandatory and expensive, was also relatively simple. Most consumers would know what they required in an auto policy.¹² Goodwin reasoned that GEICO could cut out the agents and market directly to consumers, thereby minimizing distribution costs, just as USAA had. Those two insights—direct selling that bypassed agents to financially secure, low-risk policyholders—put GEICO in a very favorable cost position relative to its competitors. Later, Buffett would write that there was “nothing esoteric” about its success: its competitive strength flowed directly from its position as the industry low-cost operator.¹³ GEICO’s method of selling—direct marketing—gave it an enormous cost advantage over competitors that sold through agents, a form of distribution so ingrained in the business of these insurers that it was impossible for them to give it up.¹⁴ Low costs permitted low prices, low prices attracted and retained good policyholders, and this virtuous cycle drove GEICO’s success.¹⁵ GEICO was superbly managed under the Goodwins. It grew volumes rapidly, and did so while maintaining unusually high profitability. When Leo Goodwin retired in 1958, he named Davidson, the man whom the 20-year-old Buffett had met on that Saturday in January 1951, as his successor.¹⁶ The transition was a smooth one, and GEICO’s prosperity continued with Davidson in the chief executive role. Volumes grew such that, by 1964, GEICO had more than 1 million policies in force.¹⁷ Between its formation in 1936 and 1975, it captured 4 percent of the auto market, and grew to be the nation’s fourth largest auto insurer.¹⁸ It looked, in Buffett’s estimation, “unstoppable.”¹⁹

But GEICO was struck by a double whammy in the 1970s. First, Davidson retired in 1970, and then both Leo and Lillian Goodwin passed away. Without a rudder, it seemed to stray from the principles that had made it successful.²⁰ When real-time access to computerized driving records became available throughout the United States in 1974, GEICO moved beyond its traditional government employee constituency to begin insuring the general public.²¹ By 1975, it was clear that it had expanded far too aggressively during a difficult recession.²² Actuaries had also made serious errors

in estimating GEICO's claims costs and reserving for losses. This faulty cost information caused it to underprice its policies, and lose an enormous amount of money.²³ Weak management, bad investment choices, and years of rapid expansion took their toll.²⁴ In 1976, GEICO stood on the brink of failure.

It was saved from collapse when Jack Byrne was appointed chief executive in 1976. Byrne took drastic remedial measures.²⁵ He organized a consortium of 45 insurance companies to take over a quarter of GEICO's policies.²⁶ To pay the remaining claims, he had GEICO undertake a stock offering that severely diluted existing stockholders.²⁷ The stock price was savaged. From its peak, it fell more than 95 percent.²⁸ Believing that Byrne could rescue GEICO, and that, despite its problems, it maintained its fundamental competitive advantage as a low-cost auto insurer, Buffett plunged into the market in the second half of 1976, buying a very large initial interest for Berkshire.²⁹ Byrne put it on a path to insuring only "government employee"-style policyholders from a much wider pool of potential insureds, and improving its reserving and pricing discipline. Though the company shrank significantly in the first few years of Byrne's tenure, Berkshire kept buying, making purchases at particularly opportune times. By 1979, GEICO had taken a step back from the precipice, but it was only half the size that it had been. While the business maintained its inherent competitive advantage—its rock-bottom operating costs—and Byrne had reserving and pricing under control, it was clear that GEICO needed help on the investment side. After searching for over a year without luck, and being turned down by the first good prospect, Byrne had whittled the field down considerably from the initial candidates. Simpson was one.³⁰ And a meeting with Buffett stood in the way.

On a Saturday morning in the summer of 1979, Simpson traveled to Omaha to meet with Buffett in his office. In the meeting Buffett said, "I think maybe the most important question is, what do you own in your personal portfolio?"³¹ Simpson told him, but Buffett didn't give away whether he was impressed or not. After talking for two to three hours, Buffett drove Simpson to the airport where they met Joe Rosenfield. Rosenfield was a good friend of Buffett's, and an impressive investor in his own right: He would almost single-handedly steer little Grinnell College's \$11 million endowment into a \$1 billion behemoth, one of the biggest *per student* for any private liberal arts school in the country.³² Simpson and Rosenfield discovered they were both big-time Chicago Cubs fans, and spent the time chatting about the team (Rosenfield would go on to acquire 3 percent of the Cubs, and, in his seventies, vowed not to die until they won a World Series).³³ After visiting with Buffett and Rosenfield, Simpson flew back to Los Angeles. Evidently Buffett found the stocks in Simpson's personal portfolio acceptable because