



GEICO: The “Growth Company” that made the “Value Investing” careers of both Benjamin Graham and Warren Buffett

In 1948, we made our GEICO investment and from then on, we seemed to be very brilliant people.

Benjamin Graham, 1976

The Security I Like Best

Warren Buffett, 1951

Becky Quick (CNBC): *“If you could keep one company that Berkshire owns, either a wholly-owned subsidiary, or that Berkshire owns a common equity in, which one would you keep and why?”*

Warren Buffett: *“I would keep GEICO. It goes back to the -- 62 years ago it changed my life. It's also a wonderful company. I would have both things going for me, but that if I hadn't gone to GEICO when I was 20 years-old and had a fellow there explain the insurance business to me, my life would be vastly different. So I just have to - - I'd have to choose GEICO.”*

CNBC interview March 13, 2013

Two of the greatest "Value" investors of all-time owe a substantial part of their wealth and public reputations – and deserved accolades - to a singular great “Growth” company, the Government Employees Insurance Company (GEICO). In the vernacular of investing, “Value” and “Growth” are most often associated with competing, mutually exclusive investing styles. It shouldn't be so, but as a +27-year veteran in the investing “business” I can assure you that this investing-style division is deeply embedded in the investment management industry. Benjamin Graham's deserved sobriquets include the “Father of Security Analysis” and the “Dean of Value Investing.” Of course Warren Buffett is known around the globe as the “Oracle of Omaha,” as well as Benjamin's Graham's “greatest” student.

Like many of us in our chosen profession, we sit on the shoulders of the greats. We hope to never stop studying and learning from the masters. I was ever fortunate to get hooked on the stock market my junior year in college in 1984. My Investments 334 professor introduced me to, and encouraged me to read about the likes of Benjamin Graham, John Templeton, Warren Buffett, Philip Fisher, John Maynard

Keynes, etc. The guiding principles of our investment philosophy at Wedgewood Partners are the classic tenets of *both* “Value” and “Growth” investing.

Buffett’s evolving investment philosophy has oft been self-described as “85% Graham and 15% Fisher.” Charlie Munger’s “Growth” influence on Buffett deserves special mention on this score. Anyone who has studied the careers of either Graham or Buffett has surely come to recognize the notable influence and impact that GEICO has had on both of these masters. Indeed, the nearly fourscore history of GEICO is a barnburner tale of birth, incredible growth, tragic near-failure, unlikely rebirth and then incredible growth once again. GEICO may have bonded Graham and Buffett even more than their significant professor-student bond. The long history of GEICO offers students of investing plenty of lessons on of both “Value” and “Growth” investing. Dare I say that the investment lessons of the GEICO story alone are so poignant and instructive to apply to one’s own investment education that *even a caveman can do it!*

Government Employees Insurance Company

Leo and Lillian Goodwin founded GEICO in 1936. At the time 50 year-old Goodwin was an accountant at San Antonio-based United Services Automobile Association (USAA). USAA was founded in 1922 by a group of U.S. Army officers to self-insure each other’s automobile insurance. Apparently at the time, Army officers were considered reckless drivers. Goodwin’s brilliant insight was an expansion of USAA’s concept - bypassing commissioned insurance salesmen and selling low cost auto insurance through the mail at discounts of 30% to 40% directly to Federal, State and municipal government employees and certain categories of enlisted military officers, who statistically had lower claims than the public as a whole. The military list of potential customers would soon expand to include active and reserve commissioned officers and the first three pay grades of non-commissioned officers, plus veterans on active duty. Government defense contractors and faculty members of colleges and universities were soon solicited.

Goodwin founded GEICO with Ft. Worth banker Cleaves Rhea. Goodwin put up \$25,000 in seed capital, Rhea and his relatives put up \$75,000. Goodwin and his wife worked literally around the clock, twelve hours every day with nary a day off. On the weekends, Mr. Goodwin drove to military bases to pitch his car insurance to young service families. Their combined salary was \$250 per month. Within their first year they had written over 3,700 policies and collected \$104,000 in premiums. \$27.62 for car insurance - ah, the good ‘ol days! In 1937 the Company’s operations were relocated to Washington, D.C. in order to be closer to the country’s largest pool of government workers.

By 1940 policies in force would grow to over 25,000 and premiums grew to \$1.6 million, plus the Company had finally booked its first underwriting profit of \$5,000 – *35 consecutive years* of profits would then ensue. In the fall of 1941, a massive

hailstorm descended upon the D.C. metro area damaging thousands of cars. Goodwin had the good business sense to quickly arrange with local auto repair shops to work around the clock exclusively for GEICO. In addition, Goodwin trucked in huge truckloads of auto glass. GEICO's reputation for customer service left an indelible mark with the locals.

By 1946 and 1947, the Company was earning premiums of \$2 to \$3 million per year. Earnings per share of \$1.29 in 1946 boomed to \$5.89 per share in 1947. With the Company's significant low-cost advantage, plus the emerging post-World War II automobile boom, the Company would go on to consistently post underwriting profit for the next 35 years in a row. The Company's low cost advantage in their core automobile insurance offering would persist and endure for decades to come. Indeed, GEICO's underwriting and loss adjustment expenses typically amounted to just 25% of premiums – at times 10-15 percentage points lower than their competitors, including such direct insurance writes as Allstate and State Farm.

Graham's journey with GEICO began in 1948. At the time the insurance industry was reeling from the sharp post-World War II inflation induced underwriting losses. In addition, the Rhea family was looking to sell part of their 75% of their ownership stake. After being spurned by larger investment houses, GEICO's investment bankers and lawyers found their way to the Graham-Newman investment partnership. Graham was able not only to put aside his long-held disdain for insurance company investments, but then he did the inexplicable – he broke his own investment rules. Graham rarely allocated more than 5% of his investment portfolio to a single investment. Graham, breaking badly, so to speak, put 25% of his partnership in GEICO. Thus, in 1948 Graham's investment partnership purchased 50% of GEICO for \$712,000. Graham's one-half purchased interest amounted to a purchase of 1,500 shares at \$475 per share (a 10% discount to book value). Graham became Chairman of the Board. The investment banker in the deal (Lorimer Davidson) joined the company as part of the transaction - and would succeed the retiring Goodwin in 1958 as CEO.

Later in 1948, the SEC determined that an investment fund was not permitted to own more than 10% of an insurance company. The SEC demanded that the sale be nullified. The Rhea family refused to take their shares. In what would turn out to be a second stroke of luck for Graham-Newman, the SEC then ruled that the sale could stand as long as Graham-Newman shares were purchased directly by the partnership's shareholders. The shares in GEICO were then distributed to the partners/shareholders of Graham-Newman in the summer of 1948 in the over-the-counter market. GEICO became a publicly traded stock. The original distribution was approximately \$27 for one share of GEICO.

In 1949, the Company's profits surged past the \$1 million mark. As an example of the low-cost advantage wielded by GEICO, in 1949 the ratio to underwriting profits to premiums was 27.5%. The same measure for the 135 stock casualty companies as calculated by A. M. Best was 6.7%. By 1950, the Company had nearly 144,000

policies in force and \$8 million in annual premiums – and licensed in just 15 states (and of course D.C.). In 1958, the Company’s addressable market more than tripled when they began to solicit nongovernmental, managerial, technical and administrative workers with the requisite outstanding driving records.

Over the next 25 years, GEICO would continue to grow, and grow... and grow. At the time of Goodwin’s retirement in 1958, an investment of \$1,000 in GEICO had grown to \$47,500. Graham and his colleagues would serve on the GEICO board for seventeen years. In 1965, Graham resigned from the board. In 1971, Jerry Newman retired. Newman nominated Warren Buffet to take his place on the GEICO board. Graham wrote the following recommendation to the board on Buffett’s behalf:

“...I am 100 percent for that idea. I have known Buffett intimately for many years, and I must say that I have never met anyone else with his combination of high character and brilliant business qualities. His record as an investment fund manager is probably unequalled. In addition, I can recommend Warren as a good-humored, easy-to-get-along-with person, who can liven up your directors meetings. He would be sure to supply more than his share of worthwhile ideas for the benefit of the GEICO companies.”

By 1972, at the Company’s then peak operating level, a single original Graham-Newman share of \$27 had grown in worth to \$16,349 – not quite the classic single cigar-puff, textbook Graham and Doddsville stock. Graham-Newman’s original 1948 investment of \$712,000 was worth over \$400,000,000 25 years later. Graham had scored a Peter Lynchian 500-bagger. The gain in GEICO would come to represent a much larger percentage of the firm’s profits than its other investments **combined**. The GEICO peak in 1972 would be short lived, and would not reach that level again over the next 10-plus years. Graham added the following postscript to the 1971/1972 edition of his seminal book *The Intelligent Investor*:

We know very well two partners who spent a good part of their lives handling their own and other people’s funds in Wall Street. Some hard experiences taught them it was better to be safe and careful rather than to try to make all the money in the world. They established a rather unique approach to security operations, which combined good profit possibilities with sound values. They avoided anything that appeared overpriced and were rather too quick to dispose of issues that had advanced to levels they deemed no longer attractive. Their portfolio was always well diversified, with more than a hundred different issues represented. In this way they did quite well through many years of ups and downs in the general market; they averaged about 20% per annum on the several millions of capital they had accepted for management, and their clients were well pleased with the results.

In the year in which the first edition of this book appeared an opportunity was offered to the partners’ fund to purchase a half-interest in a growing enterprise. For some reason the industry did not have Wall Street appeal at the time and the deal had been turned down by quite a few important houses. But the pair was impressed by the company’s possibilities; what was decisive for them was that the price was moderate in relation to current earnings and asset value. The partners went ahead with the acquisition, amounting in dollars to about one-

fifth of their fund. They became closely identified with the new business interest, which prospered.

In fact it did so well that the price of its shares advanced to two hundred times or more than the price of the half-interest. The advance far outstripped the actual growth in profits, and almost from the start the quotation appeared much too high in terms of the partners' own investment standards. But since they regarded the company as a sort of "family business," they continued to maintain a substantial ownership of the shares despite the spectacular price rise. A large number of participants in their funds did the same, and they became millionaires through their holding in this one enterprise, plus later-organized affiliates.

Ironically enough, the aggregate of profits accruing from this single investment-decision far exceeded the sum of all the others realized through 20 years of wide-ranging operations in the partners' specialized fields, involving much investigation, endless pondering, and countless individual decisions.

Are there morals to this story of value to the intelligent investor? An obvious one is that there are several different ways to make and keep money on Wall Street. Another, not so obvious, is that one lucky break, or one supremely shrewd decision - can we tell them apart? - may count for more than a lifetime of journeyman efforts. * But behind the luck, or the crucial decision, there must usually exist a background of preparation and disciplines capacity. One needs to be sufficiently established and recognized so that these opportunities will knock at his particular door. One must have the means, the judgment, and the courage to take advantage of them.

Of course, we cannot promise a like spectacular experience to all intelligent investors who remain both prudent and alert through the years. We are not going to end with J. J. Raskob's slogan that we made fun of at the beginning: "Everybody can be rich." But interesting possibilities abound on the financial scene, and the intelligent and enterprising investor should be able to find both enjoyment and profit in this three-ring circus. Excitement is guaranteed.

*Veracity requires the admission that the deal almost fell through because the partners wanted assurance that the purchase would be 100% covered by asset value. A future \$300 million or more in market gain turned on, say \$50,000 of accounting items. By dumb luck they got what they insisted on.

The Security I (Still) Like Best

Buffett entered the GEICO tale in 1950. While attending graduate school at Columbia University Buffett ran across an insurance filing that listed Graham (his professor and burgeoning mentor) as GEICO's Chairman. Here Buffett's tells his story of that fateful visit in his 1995 Chairman's Letter:

I've had a 45-year association with GEICO, and though the story has been told before, it's worth a short recap here. I attended Columbia University's business school in 1950-51, not because I cared about the degree it offered, but because I wanted to study under Ben Graham, then teaching there. The time I spent in Ben's classes was a personal high, and quickly induced me to learn all I could about my hero. I turned first to Who's Who in America, finding there, among other things, that Ben was Chairman of Government Employees Insurance Company, to me an unknown company in an unfamiliar industry.

A librarian next referred me to Best's Fire and Casualty insurance manual, where I learned that GEICO was based in Washington, D.C. So on a Saturday in January, 1951, I took the train to Washington and headed for GEICO's downtown headquarters. To my dismay, the building was closed, but I pounded on the door until a custodian appeared. I asked this puzzled fellow if there was anyone in the office I could talk to, and he said he'd seen one man working on the sixth floor.

And thus I met Lorimer Davidson, Assistant to the President, who was later to become CEO. Though my only credentials were that I was a student of Graham's, "Davy" graciously spent four hours or so showering me with both kindness and instruction. No one has ever received a better half-day course in how the insurance industry functions nor in the factors that enable one company to excel over others. As Davy made clear, 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. After my session with Davy, I was more excited about GEICO than I have ever been about a stock.

When I finished at Columbia some months later and returned to Omaha to sell securities, I naturally focused almost exclusively on GEICO. My first sales call on my Aunt Alice, who always supported me 100% was successful. But I was then a skinny, unpolished 20-year-old who looked about 17, and my pitch usually failed. Undaunted, I wrote a short report late in 1951 about GEICO for "The Security I Like Best" column in The Commercial and Financial Chronicle, a leading financial publication of the time. More important, I bought stock for my own account.

You may think this odd, but I have kept copies of every tax return I filed, starting with the return for 1944. Checking back, I find that I purchased GEICO shares on four occasions during 1951, the last purchase being made on September 26. This pattern of persistence suggests to me that my tendency toward self-intoxication was developed early. I probably came back on that September day from unsuccessfully trying to sell some prospect and decided despite my already having more than 50% of my net worth in GEICO to load up further. In any event, I accumulated 350 shares of GEICO during the year, at a cost of \$10,282. At yearend, this holding was worth \$13,125, more than 65% of my net worth.

You can see why GEICO was my first business love. Furthermore, just to complete this stroll down memory lane, I should add that I earned most of the funds I used to buy GEICO shares by delivering The Washington Post, the chief product of a company that much later made it possible for Berkshire to turn \$10 million into \$500 million.

Alas, I sold my entire GEICO position in 1952 for \$15,259, primarily to switch into Western Insurance Securities. This act of infidelity can partially be excused by the fact that Western was selling for slightly more than one times its current earnings, a p/e ratio that for some reason caught my eye. But in the next 20 years, the GEICO stock I sold grew in value to about \$1.3 million, which taught me a lesson about the inadvisability of selling a stake in an identifiably-wonderful company.

Upon graduating from Columbia, Graham refused to hire his only A+ student in his 27 years teaching at Columbia - even for a salary of \$0. (Buffett has oft quipped that Graham had perfectly calculated Buffett's true intrinsic value at the time.) So, from 1951 through 1954, Buffett tried his hand at being a stockbroker at his father's small brokerage Buffett-Falk & Co. Finally, in 1954 Graham relented and hired Buffett as a security analyst at Graham-Newman. Buffett would then form the Buffett Partnership after leaving Graham-Newman in 1956.

Buffett's hiatus from GEICO as an investor would last over the proceeding two decades, yet the Company's fortune - and later misfortunes - were never far from his mind. The GEICO under Graham's tenure would dissolve into a morass by the 1970's. The Company's unbridled growth had begun to sow the seeds of its demise. By 1974, the Company was reeling. The government had begun to legislate no-fault insurance and mandated price reductions. Concomitant with new regulations and inflation, the Company's underwriting executives had made a series of egregious pricing errors extending its clientele to higher risk categories. Inadequate provision for future claims had raised their ugly head too. The Company was woefully under reserved. Thus began a stream of significant losses. In 1975, the Company lost \$126 million and \$40 million during the first half of 1976. Bankruptcy was a very real risk - and the Washington, D.C. insurance commissioner was poised to declare GEICO bankrupt. Buffett even interceded in 1975 with a visit to then CEO Norm Gidden. Yet inexplicably Gidden turned a deaf ear to Buffett's entreaties and warnings. GEICO was on the brink of the largest insolvency in the history on the U.S. insurance industry.

The Company's shares, which had traded as high as \$61 in 1972 and \$42 in 1974, were down to just under \$5. By the time of the 1976 annual shareholders meeting at the Washington Statler Hilton, panic was in the air and pitchforks were drawn. Within a month, CEO Peck was booted. By then, the stock was little more than \$2 per share. (A sad aside: The Goodwin's had bequeathed their stock to their son Leo, Jr., who had margined the stock to the hilt. Tragically, after the stock crashed, he took his life.)

Enter the "The Babe Ruth of Insurance." In May 1976, the GEICO board of directors hired former Traveler's executive John Byrne as chairman, president and CEO. Byrne, brusque as they come, had recently cemented his industry chops at Traveler's home and auto insurance lines. Byrne wasted little time in turning around GEICO's operations. "Operation Bootstrap" commenced post-haste. Byrne was ruthless in cutting costs, increasing rates and re-underwriting the Company's entire book of business. These measures included firing 4,000 of the Company's 7,000 employees, closing 100 offices, exiting the Massachusetts and Jew Jersey markets and immediately raising rates by 40%. Byrne was also uniquely successful in putting together a consortium of 27 of the Company's competitors to jointly reinsure GEICO's existing book of business.

Byrne was so successful that GEICO's statutory capital by the end of 1976 was back up to \$137 million and the Company's surplus topped \$250 million - the highest level in the Company's then 43-year history. GEICO returned to profitability in just one year. In the same year, 1977, the Company declared a dividend - just \$.01. By 1979, the Company's profits reached \$220 million. Buffett's Ruthian sobriquet of Byrnes proved quite fitting.

Shortly after taking the reigns at GEICO that May, Buffett reached out to his then dear friend Kay Graham, CEO of the Washington Post, to broker a meeting with

Byrne. Kay Graham reached out to Byrne, yet Byrne apparently snorted, “Who’s Buffett?” The next phone call that Byrne received was from none other than Lorimer Davidson (who would live to 97 years of age) who’s choice and off-colored words quickly convinced Byrne to accept the Buffett meeting. Buffett and Byrne met long into the night at Kay Graham’s Georgetown residence discussing the intricacies of GEICO and Byrne’s plan for GEICO’s survival.

Buffett was so impressed by Byrne that he started buying GEICO stock the very next morning. The first order was for 500,000 shares at \$2 1/8. Buffett opened up Berkshire’s thick wallet for even more. He ultimately invested \$19 million in a Salomon Brothers led convertible preferred stock issuance of \$75 million, plus \$4.1 million at an average price of \$2.55 per share. Buffett’s fully converted cost-basis was just \$1.31 per share. Byrne was instrumental with Salomon in the convertible deal after eight other investment banks balked at the deal. Buffett played no small role himself parlaying his growing reputation to help sway insurance regulators at bay from pulling GEICO’s state licensees.

By 1980 Buffett had sized-up Berkshire’s investment in GEICO to \$45 million (one-third of all of GEICO). By 1981, GEICO would represent 31% of Berkshire’s entire equity portfolio. (Shades of Buffett’s 1964 career score in American Express’ salad oil scandal.) At the close of 1982, Berkshire’s 35% ownership of GEICO represented approximately \$250 million of annual insurance premiums – an amount larger than Berkshire’s own direct premium volume. As 1984 rolled around, GEICO continued to impress and accelerate. Berkshire’s GEICO ownership had reached 36%, and their interest in GEICO’s direct property/casualty volume of \$885 million amounted to \$320 million – more than double Berkshire’s own premium volume. 1985 would mark the peak of GEICO’s stock market value as a percentage (50%) of Berkshire’s common stock portfolio. Over the course of the next ten years, GEICO would prosper. Mirroring the Company’s rebirth of profitable growth, cash dividends would be increased for the next *seventeen consecutive* years. By 1994 the dividend would reach \$1.00 per share. GEICO’s rising stream of dividends would buttress the coffers of Berkshire to the tune of \$180 million dollars – more than four times Buffett’s investment in just dividends alone! Along the way too was Buffett’s growing desire to own GEICO lock-stock-and-barrel.

In Buffett’s 1987 Chairman’s Letter he informed Berkshire shareholders that GEICO, along with Capital Cities/ABC and The Washington Post would now be deemed “permanent” holdings. He wrote:

However, our insurance companies own three marketable common stocks that we would not sell even though they became far overpriced in the market. In effect, we view these investments exactly like our successful controlled businesses—a permanent part of Berkshire rather than merchandise to be disposed of once Mr. Market offers us a sufficiently high price. To that, I will add one qualifier: These stocks are held by our insurance companies and we would, if absolutely necessary, sell portions of our holdings to pay extraordinary insurance losses. We intend, however, to manage our affairs so that sales are never required.

By year-end 1987, the incredible success of Buffett's GEICO investment (15X bagger), The Washington Post (27X bagger) and the size of his Capital Cities/ABC investment had a combined market value of \$1.7 billion – or approximately 75% of the net worth at Berkshire. The after-tax operating earnings growth at GEICO by 1987 had increased to \$9.01, far eclipsing Buffett's average stock cost of \$6.67 per share. Fast forwarding to 1995, Berkshire's marketable securities per-share over the previous thirty years had grown from \$4 per share to \$22,088 per share – a stunning compounded growth rate of 33.4%.

On and off again informal discussions of a Berkshire-GEICO combo had taken place for quite a few years; however, the first formal acquisition discussions would have to wait until late summer in 1994. Buffett had proposed a tax-free stock swap. GEICO executives Sam Butler and Lou Simpson balked at the proposal for dividend and tax-related reasons. The next proposal by Buffett (reluctantly) was a new issue of Berkshire convertible preferred. This proposal was nixed by GEICO on price. Negotiations continued into the spring and summer of 1995. GEICO countered that they would accept an all-cash deal at \$70 per share. Simply put, GEICO wanted cash and Buffett didn't have \$2 billion in pocket change. While Buffett and Munger negotiated with GEICO on the east coast, events were stirring on the west coast. The Magic Kingdom would soon turn Berkshire Hathaway into an even greater magic kingdom of its own. On August 1, 1995, Disney announced their acquisition of Cap Cities/ABC for \$19 billion. At the time, Berkshire owned a cool 20 million shares of Cap Cities/ABC (13% of the Company). The cash portion of the deal was \$65 per share (plus 1 share of Disney stock). Buffett's \$345 million investment in Cap Cities/Disney was now worth nearly \$2.5 billion. Buffett's elephant gun was now cash-cocked and he and Munger quickly agreed to GEICO's \$70 non-negotiable price. On August 25, brought the announcement of the GEICO acquisition. Buffett's mentor once bought 50% of GEICO for \$712,000 – Buffett upped the ante nearly 50 years later by \$2.3 billion. From the real panic low's set in the spring of 1976 of \$2.25, by the fall of 1995, GEICO's stock had soared to over \$300 (split-adjusted).

By the end of 1995, Berkshire's ownership in GEICO had increased to 51% via share buybacks. Buffett's purchase of the remaining 49% in GEICO for \$2.3 billion had thus created an effective *48-bagger* on Berkshire Hathaway's earlier GEICO investment of \$46 million.

At the time of the GEICO acquisition, GEICO had grown to the nation's 7th largest automobile insurer, insuring over 3.7 million autos. So now as a wholly owned subsidiary of Berkshire, Buffett gets his hands not only on GEICO's underwriting profits, but also the Company's growing float of \$3 billion. Buffett on the GEICO acquisition (and a tutorial on float):

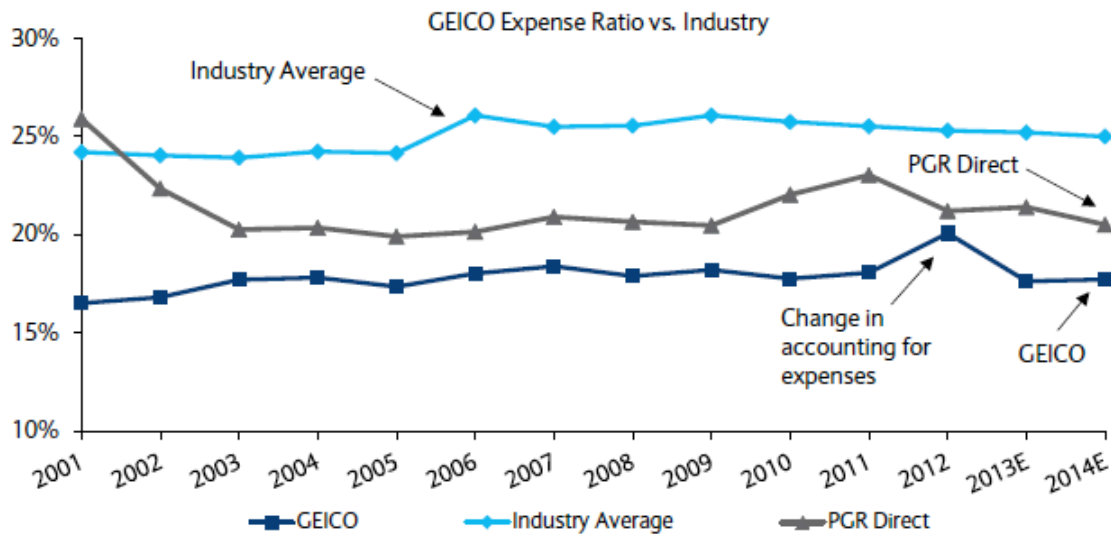
Since 1967, when we entered the insurance business, our float has grown at an annual compounded rate of 20.7%. In more years than not, our cost of funds has been less than nothing. This access to "free" money has boosted Berkshire's performance in a major way.

Any company's level of profitability is determined by three items: (1) what its assets earn; (2) what its liabilities cost; and (3) its utilization of "leverage" that is, the degree to which its assets are funded by liabilities rather than by equity. Over the years, we have done well on Point 1, having produced high returns on our assets. But we have also benefitted greatly to a degree that is not generally well understood because our liabilities have cost us very little. An important reason for this low cost is that we have obtained float on very advantageous terms. The same cannot be said by many other property and casualty insurers, who may generate plenty of float, but at a cost that exceeds what the funds are worth to them. In those circumstances, leverage becomes a disadvantage.

Since our float has cost us virtually nothing over the years, it has in effect served as equity. Of course, it differs from true equity in that it doesn't belong to us. Nevertheless, let's assume that instead of our having \$3.4 billion of float at the end of 1994, we had replaced it with \$3.4 billion of equity. Under this scenario, we would have owned no more assets than we did during 1995. We would, however, have had somewhat lower earnings because the cost of float was negative last year. That is, our float threw off profits. And, of course, to obtain the replacement equity, we would have needed to sell many new shares of Berkshire. The net result more shares, equal assets and lower earnings would have materially reduced the value of our stock. So you can understand why float wonderfully benefits a business, if it is obtained at a low cost.

Our acquisition of GEICO will immediately increase our float by nearly \$3 billion, with additional growth almost certain. We also expect GEICO to operate at a decent underwriting profit in most years, a fact that will increase the probability that our total float will cost us nothing. Of course, we paid a very substantial price for the GEICO float, whereas virtually all of the gains in float depicted in the table were developed internally.

GEICO Expense Ratio vs. Peers



Source: Company data, A.M. Best, Insurance Information Institute, Barclays Research estimates

GEICO hit the ground running in 1996. Under the direction of 35-year GEICO veteran Tony Nicely (by 2012, maybe the most named Berkshire manager in Buffet's

annual Chairman’s Letter) – and with the influence of Buffett, GEICO quickly instituted a most effective and elegant company-wide bonus plan to enhance the company’s moat-like low-cost advantage. Henceforth, the annual profit sharing contribution and employee bonus plan would be calculated by two metrics – growth in voluntary auto policies and underwriting profitability on policies on GEICO’s books for at least one “seasoned” year. 1996 would turn out to be GEICO’s best year since 1976 as their voluntary auto policies grew 10%. The single best year during the previous twenty had been an 8% growth in policies. 1997 saw only accelerated growth on all fronts at GEICO. New voluntary policies clocked in at over 900,000 – nearly triple from 1993’s level of 350,000. Policies in force almost reached 3,000,000 – up about 50% from 1993. GEICO employees enjoyed a whopping contribution of 27% of their base contribution to their profit sharing plan. 1998 saw a dramatic increase to expand the gospel of GEICO’s low-cost auto insurance as the company’s marketing budget was increased to nearly \$150 million – almost three times the amount spent in 1997.

Buffett didn’t let Tony Nicely take his foot off the gas pedal in both 1998 and 1999. The year before Buffett acquired GEICO; the company spent \$33 million in marketing and had a force of 652 telephone counselors. By the end of 1999, GEICO spent \$242 million in marketing and grew their counselors to over 2,600. GEICO’s growth went nearly ballistic. New annual auto policies grew nearly 1.25 million and 1.65 million in 1998 and 1999, respectively. Auto policies in force at yearend 1999 exceeded 4.3 million. GEICO’s market share had been stuck at about 2% the decade before Nicely took the reigns in 1993. At the end of 1999 it had quickly doubled to 4.1%. GEICO’s gain in market share had come at the expense of State Farm and Allstate. The year-over year growth of policies in force at State Farm has been flat since 2003. Allstate has fared even worse. Their cumulative policy in force growth has been -8% since 2008, and flat late since 2005. The table below chronicles the growth in GEICO over the next decade.

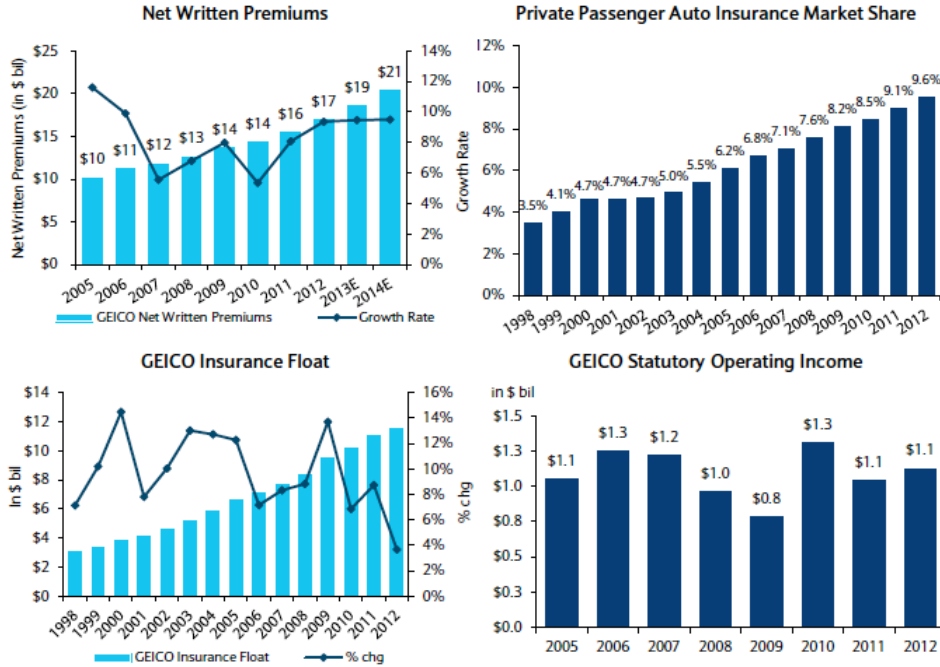
Figures in Millions		2010	2009	2008	2007	2006	2005	2004	2003	2002	2001	2000	1999
GEICO	Year End Float	10272	9613	8454	7768	7171	6692	5960	5287	4678	4251	3943	3444
	Premiums Earned	14283	13576	12479	11806	11055	10101	8915	7784	6670	6060	5610	4757
	Underwriting Gain/Loss	1117	649	916	1113	1314	1221	970	452	416	221	-224	24
	Combined Ratio	92.2%	95.2%	92.7%	90.6%	88.1%	87.9%	89.1%	94.2%	93.8%	96.4%	104.0%	99.5%
	Cost of Float	-10.9%	-6.8%	-10.8%	-14.3%	-18.3%	-18.2%	-16.3%	-8.5%	-8.9%	-5.2%	5.7%	-0.7%
	% of Total BRK Float	15.6%	15.5%	14.5%	13.2%	14.1%	13.6%	12.9%	12.0%	11.3%	12.0%	14.1%	13.6%

Source: Rational Walk

By 2012, the growth at GEICO had been simply superlative under the Buffett-Nicely Murderer’s Row reign. Market share was up almost four-fold to 9.6%. Annual auto premiums had grown five-fold to \$17 billion. Accumulated underwriting profit (pre-tax) clocked in at just over \$10 billion. Gecko, GEICO’s reptilian ad man, plus the Caveman would make their debuts in 1999 and 2004, respectively. By 2012,

these two pitchmen would happily spend approximately \$1 billion each year hawking GEICO - or three times as much as the company's three largest rivals combined. GEICO is on course to become the nation's second largest auto insurer.

GEICO Metrics



Note: Operating income excludes after-tax net realized investment gains and losses.
 Source: Company data, SNL, Barclays Research

Near and dear to Buffett's heart is float. By 2012, GEICO's float had increased to \$11.5 billion from 1995's level of \$3 billion. In addition, by 2012, GEICO's underwriting profits had accumulated to \$9 billion. How much of this float and profit over the years was then in turn invested into the likes of Coca-Cola? Although Berkshire holds a slug of Coca-Cola stock via GEICO's float, we'll never know the exact and full extent of the history of the Simpson-Buffet GEICO investments, but we do know that the totality of GEICO's impact on Berkshire Hathaway have been manifold.

Buffett's all in cost of GEICO on Berkshire's books is about \$2.4 billion. A comparable company is Progressive Corporation. GEICO and Progressive are similarly sized in both annual premiums written and policies in force. The market capitalization of Progressive is nearly \$14 billion. We take Buffett on his word that when he states that the book cost of GEICO is a fraction of its economic worth.

Some may offer up Buffett's investment in Coca-Cola as his greatest. They would have a compelling argument. By any measure, Buffett's two and half-decade investment of \$1.3 billion in Coca-Cola, currently worth just over \$17 billion, certainly merits consideration. Throw in the not-so-minor matter of about \$4.6

billion in accumulated Coca-Cola dividends since 1988 and perhaps the scale does tip in Coca-Colas' favor over GEICO. Heck, the approximate flow of \$3 billion in dividends from 1998 through 2011 certainly soothed the pain waiting for Coca-Cola's stock to recover back to the 1998 exuberant highs of \$33. Buffett's current dividend yield to cost is a mind-numbing 34%. While Buffett's investment in Coca-Cola is perhaps second to none for him in terms of raw size, the *transformative* nature of his GEICO investments, surely trumps Coca-Cola.

David A. Rolfe, CFA
Chief Investment Officer

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The Security I Like Best

WARREN E. BUFFETT

Buffett-Falk & Co., Omaha, Nebr.

Government Employees Insurance Co.

Full employment, boomtime profits and record dividend payments do not set the stage for depressed security prices. Most industries have been riding this wave of prosperity during the past five years with few ripples to disturb the tide.

The auto insurance business has not shared in the boom. After the staggering losses of the immediate



Warren E. Buffett

postwar period, the situation began to right itself in 1949. In 1950, stock casualty companies again took it on the chin with underwriting experience the second worst in 15 years. The recent earnings reports of casualty companies, particularly those with the bulk of writings in auto lines, have diverted bull market enthusiasm from their stocks. On the basis of normal earning power and asset factors, many of these stocks appear undervalued.

The nature of the industry is such as to ease cyclical bumps. Auto insurance is regarded as a necessity by the majority of purchasers. Contracts must be renewed yearly at rates based upon experience. The lag of rates behind costs, although detrimental in a period of rising prices as has characterized the 1945-1951 period, should prove beneficial if deflationary forces should be set in action.

Other industry advantages include lack of inventory, collection, labor and raw material problems. The hazard of product obsolescence and related equipment obsolescence is also absent.

Government Employees Insurance Corporation was organized in the mid-30's to provide complete auto insurance on a nationwide basis to an eligible class including: (1) Federal, State and municipal government employees; (2) active and reserve commissioned officers and the first three pay grades of non-commissioned officers of the Armed Forces; (3) veterans who were eligible when on active duty; (4) former policyholders; (5) faculty members of universities, colleges and schools; (6) government contractor employees engaged in defense work exclusively, and (7) stockholders.

The company has no agents or branch offices. As a result, policyholders receive standard auto insurance policies at premium discounts running as high as 30% off manual rates. Claims are handled promptly through approximately 500 representatives throughout the country.

The term "growth company" has been applied with abandon during the past few years to companies whose sales increases represented little more than inflation of prices and general easing of business competition. GEICO qualifies as a legitimate growth company based upon the following record:

Year—	Premiums Written	Policyholders
1936---	\$103,696.31	3,754
1940---	768,057.86	25,514
1945---	1,638,562.09	51,697
1950---	3,016,975.79	143,944

Of course the investor of today does not profit from yesterday's growth. In GEICO's case, there is reason to believe the major portion of growth lies ahead. Prior to 1950, the company was only licensed in 15 of 50 jurisdictions including D. C. and Hawaii. At the beginning of the year there were less than 3,000 policyholders in New York State. Yet 25% saved on an insurance bill of \$125 in New York should look bigger to the prospect than the 25% saved on the \$50 rate in more sparsely settled regions.

As cost competition increases in importance during times of recession, GEICO's rate attraction should become even more effective in diverting business from the brother-in-law. With insurance rates moving higher due to inflation, the 25% spread in rates becomes wider in terms of dollars and cents.

There is no pressure from agents to accept questionable applicants or renew poor risks. In States where the rate structure is inadequate, new promotion may be halted.

Probably the biggest attraction of GEICO is the profit margin advantage it enjoys. The ratio of underwriting profit to premiums earned in 1949 was 27.5% for GEICO as compared to 3.7% for the 135 stock casualty and surety companies summarized by Best's. As experience turned for the worse in 1950, Best's aggregate's profit margin dropped to

3.0% and GEICO's dropped to 18.0%. GEICO does not write all casualty lines; however, bodily injury and property damage, both important lines for GEICO, were among the least profitable lines. GEICO also does a large amount of collision writing, which was a profitable line in 1950.

During the first half of 1951, practically all insurers operated in the red on casualty lines with bodily injury and property damage among the most unprofitable. Whereas GEICO's profit margin was cut to slightly above 9%, Massachusetts Bonding & Insurance showed a 16% loss, New Amsterdam Casualty an 8% loss, Standard Accident Insurance a 9% loss, etc.

Because of the rapid growth of GEICO, cash dividends have had to remain low. Stock dividends and a 25-for-1 split increased the outstanding shares from 3,000 on June 1, 1948, to 250,000 on Nov. 10, 1951. Valuable rights to subscribe to stock of affiliated companies have also been issued.

Benjamin Graham has been Chairman of the Board since his investment trust acquired and distributed a large block of the stock in 1948. Leo Goodwin, who has guided GEICO's growth since inception, is the able President. At the end of 1950, the 10 members of the Board of Directors owned approximately one-third of the outstanding stock.

Earnings in 1950 amounted to \$3.92 as contrasted to \$4.71 on the smaller amount of business in 1949. These figures include no allowance for the increase in the unearned premium reserve which was substantial in both years. Earnings in 1951 will be lower than 1950, but the wave of rate increases during the past summer should evidence themselves in 1952 earnings. Investment income quadrupled between 1947 and 1950, reflecting the growth of the company's assets.

At the present price of about eight times the earnings of 1950, a poor year for the industry, it appears that no price is being paid for the tremendous growth potential of the company.

This is part of a continuous forum appearing in the "Chronicle," in which each week, a different group of experts in the investment and advisory field from all sections of the country participate and give their reasons for favoring a particular security.



**GEICO: The “Growth” company that made the
“Value” careers of both Benjamin Graham and
Warren Buffett**

Presented by

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St. Louis, Missouri**

**10th Annual Value Investor Conference
University of Nebraska at Omaha
College of Business
Mammel Hall
Omaha, Nebraska
May 3, 2013**

GEICO Timeline

- **Founded in 1936 in San Antonio by Leo and Lillian Goodwin.**
- **\$100,000 in seed capital.**
- **\$25,000 by the Goodwin's and \$75,000 by the Rhea family.**
- **Typical auto policy \$27.50.**
- **1937: 3,700 policies with \$104,000 in premiums.**
- **1937: Company relocated in Washington, D.C.**
- **1940: Company books first underwriting profit. 25,000 policies in force.**
- **1941: Hail storm in D.C. cements Company's service reputation.**
- **1940-1974: 35 consecutive years of profits.**

Graham-Newman Timeline

- **1948: Members of Rhea want to sell their portion of Company.**
- **1948: Graham-Newman buys 50% of GEICO for \$712,000. Benjamin Graham becomes Chairman of the Board.**
- **1948: SEC finally approves the purchase via a distribution to Graham-Newman's partners/shareholders.**
- **1948: Original OTC distribution \$27 for one share.**
- **1950: GEICO licensed in 15 states. 144,000 policies in force. \$8 million in premiums.**
- **1958: Triples addressable market by soliciting non-government professionals.**
- **1958: Leo Goodwin retires. Replaced by Lorimer Davidson. \$10,000 invested in GEICO had grown to \$475,000.**
- **1965: Graham retires from GEICO board.**
- **1971: Jerry Newman retires from GEICO board and Warren Buffett nominated to replace Newman on the board.**
- **1972: Graham-Newman's original \$712,000 investment worth over \$400,000,000 – or more than *all of Graham-Newman partnership profits combined!***

Warren Buffett Timeline

- **1950: While studying under Graham at Columbia University, Buffett discovers that Graham is Chairman of GEICO.**
- **1951: Buffett travels to GEICO in D.C. on a Saturday and gets a daylong insurance tutorial from Lorimer “Davy” Davidson.**
- **1951: Upon graduation, Buffett moves back to Omaha and joins his father’s brokerage firm. He spends most of his time hawking GEICO to family and friends.**
- **1951: Buffett invests over 50% of his net worth in GEICO (350 shares @ \$29 3/8). GEICO closes at \$37 1/2 at year-end.**
- **Buffett writes “The Security I Like Best” in *The Commercial and Financial Chronicle* on December 6, 1951**
- **1952: Buffett sells his GEICO stock at \$43 5/8 to purchase Western Insurance Securities at 1X earnings.**
- **Buffett’s original \$10,282 investment in GEICO would grow to \$1.3 million over the next 20 years.**

Berkshire Hathaway Timeline - Part I

- **1974: Cracks emerge in GEICO due to unbridled go-go growth.**
- **1974: No-fault insurance, inflation and poor underwriting leaves GEICO woefully under reserved.**
- **1975: \$124 million in losses.**
- **1975: Buffett's warnings in a personal visit to CEO Gidden go unheeded.**
- **1976: \$40 million in losses first half of the year.**
- **1976: Stock falls from high of \$61 in 1972, to \$42 in 1974 to \$2 in the spring of 1976. Gidden out. Jack Byrne from Travelers in.**
- **1976: Byrne fires 50% of employees, raises rates by 40% and tells N.J. insurance commissioner to "go impregnate yourself."**
- **1976: Buffett lurking in the wings asks Kay Graham of WaPo to broker a meeting with Byrne. Byrne says "Buffett who?" and refuses meeting. Davy Davidson calls Byrne and reads him the riot act for refusing meeting. Buffett and Byrne meet late into the night and morning discussing GEICO at Graham's Georgetown estate.**
- **1976: Buffett begins buying GEICO stock the very next morning. First trade 500,000 shares at 2 1/8. Buffett's all-in investment would come to \$19 million in a convertible preferred, plus \$4.1 million @ \$2.55 per share. Buffett's fully converted cost-basis was approx. \$1.31 per share.**
- **1977: Byrne returns GEICO back to profitability.**

Berkshire Hathaway Timeline – Part II

- **1980: Buffett sizes up Berkshire’s GEICO investment to \$45 million – or 33% of GEICO.**
- **1981: GEICO 31% of Berkshire’s equity portfolio.**
- **1982: Berkshire’s 35% “look-through” ownership of \$250 million in GEICO’s annual insurance premiums greater than own direct insurance premiums.**
- **1984: Berkshire’s 36% “look-through” ownership of \$320 million in GEICO’s annual insurance premiums double Berkshire’s own direct insurance premiums.**
- **1985: GEICO investment (\$596 million) 50% of Berkshire’s equity portfolio – a peak.**
- **1984: Cumulative GEICO dividends \$180 million.**
- **1987: Buffett’s Chairman’s Letter names GEICO (and Cap Cities/ABC and WaPo) “permanent holdings.”**
- **1990: GEICO investment worth \$1,044,625,000.**

Berkshire Hathaway Timeline – Part III

- **1994: GEICO investment worth \$1,678,250,000.**
- **1994: Buffett initiates formal merger and acquisition discussions with GEICO.**
- **1994: Buffett proposes Berkshire-GEICO stock swap. GEICO balks.**
- **1995: Buffett proposes new issue of Berkshire preferred as acquisition currency. GEICO balks. GEICO wants all-cash deal \$70. Buffett does not have the cash.**
- **1995: On August 1, Disney announces their acquisition of Cap Cities/ABC. Buffett's Cap Cities/ABC investment of \$345 million now worth nearly \$2.5 billion.**
- **1995: On August 25, Buffett announces Berkshire's acquisition of the remaining 49% of GEICO for \$2.3 billion.**
- **From the real panic low's set in the spring of 1976 of \$2.25, by the fall of 1995, GEICO's stock had soared to *over \$300* (split-adjusted).**
- **1996: GEICO's best year of policy growth (+10%) in 20 years.**
- **1999: Buffett and Tony Nicely increase marketing budget to \$242 million from \$33 million in 1995. New auto policy growth of 1.65 million. Policies in force +4.3 million.**
- **1996-2012: Market share up 4X to 9.6%. Annual auto premiums up 5X to \$17 billion. Ad spending +\$1 billion from \$33 million. Cumulative underwriting profits since 1995 +10 billion. Float up 4X to \$12 billion. Conservative valuation of GEICO \$15 billion.**