

## INVESTMENT LETTER

### A Dream about Warren Buffett and Railroads

December 9, 2010

I was dreaming. Warren Buffett and I were having dinner in Omaha, Nebraska, home of Berkshire Hathaway Inc. (NYSE: BRK).

Warren Buffett might be surprised to know that I have dreamed about him. This is no surprise, however, to me. I am fascinated by finance, money, and how to work most efficiently, and with the least possible risk, to accumulate wealth, and Warren Buffett's name is synonymous with making money efficiently.

There was a time, especially when I was in college at Swarthmore, that my highest priorities consisted of having an intense Saturday night date. I would have dreams with romantic content, but now my dreams are based on investments and money, not women.

One common theme in my dreams is this: I am having dinner with Warren Buffett at Gorat's, his favorite restaurant in Omaha. I am enthralled watching his brilliant mind at work, enjoying every moment of his wisdom and his humor, admiring his ability to cut to the essence of the matter, making simple what the bombastic and insecure strive to make complicated.

There is the yuppie or young urban professional, a stereotype, a conveniently drawn picture, of someone, probably in their early thirties to forties, whose career is on the rise, and whose spending is on the rise as well, often with a trajectory steeper than the rise in his (or her) paycheck. The yuppie, or senior urban professional, on the other hand, is interested in investing and savings, and is less excited about spending money than a yuppie. I have always had yuppie values. In any case, I am now a yuppie.

Some things about being a yuppie are not so good: when you walk up to the second floor at the St. John Health Club in Tulsa, OK to do some elliptical work or some training with light weights, it is unlikely that the women working out will be distracted by your physique. It is unlikely that you will be mistaken for one of the men on the cover

*Our investment letter mission: To write research that offers, in a lively and succinct style, hard-to-find facts about a company, and research that also provides occasional, but not guaranteed, flashes of humor.*

#### Investment Thesis:

**Kansas City Southern Industries (NYSE: KSU)**  
and  
**Union Pacific Corporation (NYSE: UNP)**

Kansas City Southern Industries (NYSE: KSU) hauls unit trains (trains transporting a single commodity from one source to one destination) of coal for eight electric generating plants in the central United States. The coal originates from the Powder River Basin in Wyoming. Burlington Northern brings the coal to Kansas City, where it is interchanged with Kansas City Southern, which takes it to utilities in Arkansas and Louisiana. Kansas City Southern reaches into Mexico and is strategically situated there, having sole rail access to the booming port of Lázaro Cárdenas, as well as a strategic position at Laredo, Texas, the second largest inland border crossing in the United States.

Union Pacific Corporation has approximately 31,953 route miles linking Pacific Coast and Gulf Coast ports with the Midwest and eastern United States.

of *Men's Health* who, open shirted, shows off abdominal muscles that are so well defined that they seem to be a product of science fiction. I do swim vigorously three mornings every week on a team that meets at the uncivilized time of 5:30 A.M., but such magazine-worthy muscles I will leave to the twenty-something underwear models.

No, this is the period of life when any experienced money manager, who has come to understand his strengths and his weaknesses, is excited to dream about money and about people like Warren Buffett, people who excel at making money year in and year out, investment professionals who use common sense and a sharp understanding of what they know and what they do not know, who are in touch with their areas of competence, and mindful of areas that present too much risk.

Mr. Buffett and I are discussing the investment outlook for American railroads. I have just told him about our positions in Union Pacific Corporation (NYSE: UNP) and Kansas City

**Southern Industries (NYSE: KSU)**. Buffett knows **Union Pacific** well. **Union Pacific** and **Berkshire's Burlington Northern** are the two largest domestic railroads, with 2009 operating revenues of approximately fourteen billion dollars each. He knows **Kansas City Southern**, but perhaps not as well as the other two. At least that is what I want to believe, because I am eager to tell him about **Kansas City Southern**, and to get the jump on him at least once.

The waiter comes along and suggests a shrimp cocktail as an appetizer. I decline, knowing that the T-bone steak as the entrée will be more than enough for me. Buffett applauds my decision, telling me that ordering at a restaurant, making selections from the menu, or filtering suggestions from the waiter or waitress is not much different—he has a remarkable ability to make concepts simple—from choosing where to put your money to work.

He uses a baseball metaphor to make his point: you can stand at the plate and wait for the pitch you like (not a perfect analogy as you could also pass up some throws that were strikes and then be called out). A hitter in baseball or an investor does not have to take the first swing, or use money on the first idea. You can take your time until you see something you like. In both cases, there is no reason to rush yourself, or to be rushed.

The steaks and the hash browns arrive. Buffett takes a bite of his T-bone and says he has two questions for me.

“One, what is your investment thesis for railroads and why do you think they can provide a superior return, better than the Standard & Poor 500? And two, what is so special about **Kansas City Southern**?”



*A Burlington Northern Santa Fe train hauls intermodal containers past downtown Tulsa. (Photo courtesy Katie Michaels-Johnson).*

“Before I answer your questions,” I say, “I do have, Warren, a frustration with you and **Berkshire** that I want to air, to get off my chest.”

“What is that?” he asks.

I tell him that my clients and I had had a position in **Burlington Northern Santa Fe Co. (NYSE: BNI)** before he, operating through **Berkshire Hathaway**, had offered one hundred dollars a share for the railroad on November 3, 2009.

“We had been glad to make an excellent return on our position, which we had purchased in March of 2009 for an average weighted cost of \$88.54 per share, but we were frustrated that we had lost an opportunity to enjoy excellent returns over many years. We had believed, and our belief is as strong as ever, that railroads would offer excellent

investment returns for many years, so we had mixed feelings when you made your offer for the railroad.

“Fortunately,” I added, there were other railroads, all with good competitive positions.”

Buffett leaned back, playing psychologist, asked the waiter for another **Cherry Coke**, and said, “Fred, I hope you can get over your frustration and move on, so lay out your global thesis.”

“First,” I replied, “is the dynamic of global trade and the opportunity it provides for railroads. Consider the shipment of tangible goods, such as cars and refrigerators, from one country to another, usually by ship, and the hauling from ports to cities on the east coast and on the mainland in the United States. The cargo at the ports is hauled by railroads.”

To understand the dynamic growth in this business, consider the following two examples:

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