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Buffett, Railroads, and the Lessons of History

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Alice Schroeder, Special to The Motley Fool
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Guest columnist Alice Schroeder is author of The Snowball: Warren Buffett and the Business of Life*. Schroeder is a noted insurance industry analyst and writer who was a managing director at Morgan Stanley.*

Berkshire Hathaway's (NYSE: BRK-A) (NYSE: BRK-B) deal to buy **Burlington Northern Santa Fe** (NYSE: BNI) isn't the first time Buffett has invested in one of his lifelong interests. His first childhood business was selling chewing gum, and he put money into Wrigley last year. His second was selling **Coca-Cola** (NYSE: KO), and Berkshire Hathaway owns 200 million shares of that company today. Buffett's relationship with the bank **Goldman Sachs** (NYSE: GS), another investment, began when his father took him to meet the firm's chairman on a 10th birthday trip to New York City.

Does Buffett actually invest out of nostalgia?
Certainly, he's a sentimental guy who's fond of the tokens of his past. He's also frequently discussed the importance of a rational temperament in investing. What, then, is the logic behind his choice to so often invest in businesses that predate his own father and even his grandfather?

Let's take railroads as an example. When Buffett was a little boy, he had only a small, single-oval train set and used to "drool" every year over the huge, multi-engine railroad diorama that the Brandeis Department Store set up in the toy department every Christmas. One of the fondest memories of his childhood was being taken to Chicago on a train by his grandfather to see a Cubs game.

Buffett's hometown of Omaha was dominated by the railroad business; trains became inescapably paired with finance in his mind at an early age. Buffett, as a boy, read biographies of early tycoons like Cornelius Vanderbilt, James Fisk, and Jay Gould, men who fought ferociously to control the Erie Railroad's stock.

Another financier who interested Buffett, Jay Cooke, pioneered modern investment banking and financed the Civil War debt of the Union government. Cooke was bankrupted by his obsession to build the Northern Pacific Railway. Buffett also became fascinated by the battle between E.H. Harriman and J.P. Morgan to corner Northern Pacific's stock, which caused the market panic of 1901 and is considered the greatest short-seller squeeze in history.

A lifelong student
Studying stories like this is one way Buffett has spent a lifetime scraping with his mental lint brush to pick up every tiny fleck of knowledge about any industry that attracts him. These are invariably the basic products and services that many people would find boring, yet to Buffett they are not numbers on a page, but exciting stories out of history peopled by lively characters who are engaged in battles of will and struggles to prevail against powerful economic forces through cycles of innovation, capital creation, and destruction.

This kind of learning is one means through which Buffett worked out the larger lessons of the railroad business, which began as a thrilling new technology that connected disparate parts of the world, evolved into a network of profitable monopolies, then fell out of favor as cheap oil and regulators put a lid on pricing power.

When Buffett considered investing in electric and water utilities, the history of railroads was a point of comparison that helped frame the decision in his head. When he invested in energy and commodity stocks, his deep knowledge of railroad economics helped him better understand energy distribution. All along, Buffett had been studying utilities and the energy businesses as well, so when he bought an electric utility and two pipelines for Berkshire, that taught him even more about railroads.

A simple lesson from railroads
For a long time, Buffett had invested in railroads only when they were cigar butts. Then they were deregulated, energy costs began to rise, and railroads became profitable once again. Berkshire first announced that it owned 10% of Burlington in April 2007.

Buffett has always said that if he likes a company well enough to own its stock, it means he likes it well enough to buy the whole thing. Eighteen months after the first announcement, that's just what he did. It's interesting that even with an 18-month head start, the rest of us have been scrambling since the announcement to catch up with the many factors that influenced his decision.

One of the best and simplest lessons that can be learned from Warren Buffett is to learn things before you need the knowledge. This, after all, is why Buffett invests so often in the businesses he's had the most time to study.

Guest contributor Alice Schroeder's biography of Warren Buffett, The Snowball*, was just released in paperback. She is a shareholder of Berkshire Hathaway. The Motley Fool owns shares of Berkshire Hathaway, which is a* Stock Advisor *and an* Inside Value *recommendation. Coca-Cola is an* Inside Value *and an* Income Investor *recommendation. The Fool has a disclosure policy.*

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