# Steer clear of shares, says Buffett

The hangover from the US equities bubble may be proportional to the binge, warns Warren Buffett – and don't go near derivatives. **David Plumb** and **Helen Stock** report from New York.

American billionaire investor Warren Buffett says almost all equities remain overvalued after three years of market declines and he doesn't plan to buy more shares in companies he already owns.

"We continue to do very little in equities," he said in excerpts of his annual letter to shareholders, which were published on the Fortune.com website this week.

Unless Buffett sees a "very high probability of at least 10 per cent pretax returns" from an equity issue, "we will sit on the sidelines", he says in the excerpts.

"Despite three years of falling prices, which have significantly improved the attractiveness of common stocks, we still find very few that even mildly interest us.

"That dismal fact is testimony to the insanity of valuations reached during The Great Bubble.

"Unfortunately, the hangover may prove to be proportional to the binge."

The so-called Oracle of Omaha also issued this advice: "Occasionally successful investing requires inactivity."

The full letter to shareholders is scheduled for publication on Saturday, US time, along with financial results of Berkshire Hathaway, Buffet's investment company, on the company's website.

In contrast to his aversion to stocks, Buffett said that last year Berkshire was "able to make sensible investments in a few 'junk' bonds and loans".

"Overall, our commitments in this sector sextupled, reaching $US8.3 billion ($A13.5 billion) by year-end," he writes.

Despite those commitments, Buffett said that investing in junk bonds and in shares were alike in that "both activities require us to make a price-value calculation and also to scan hundreds of securities to find the very few that have attractive reward/risk ratios".

On the other hand, he acknowledged that junk bonds involved "enterprises that are far more marginal". "Therefore, we expect that we will have occasional large losses in junk issues. So far, however, we have done reasonably well in this field."

Warren Buffett says derivatives are "financial weapons of mass destruction".

The excerpts on the Fortune.com website don't name the issues that Berkshire bought last year.

Buffett is scathing in the letter to shareholders about derivatives, calling derivatives contracts "financial weapons of mass destruction, carrying out dangers that while now latent are potentially lethal".

The billionaire, whose company is seeking to divest itself of a derivatives business tied to its General Re purchase, also worries that substantial credit risk has become concentrated "in the hands of relatively few derivatives dealers".

Buffett said he and Berkshire Hathaway's vice-chairman, Charlie Munger, viewed derivatives as "time bombs, both for the parties that deal in them and the economic system".

He noted that before a derivatives contract was settled the counterparties could often record "huge" profits and losses on their current earnings statements "without so much as a penny changing hands".

"The range of derivatives contracts is limited only by the imagination of man (or sometimes, so it seems, madmen)," he continues, citing the bankrupt US energy trader Enron as a prime example. There, newsprint and broadband derivatives due to be settled many years hence were put on the books.

Another problem with derivatives, Buffett writes, is that "they can exacerbate trouble that a corporation has run into for completely unrelated reasons".

"This pile-on effect occurs because many derivatives contracts require that a company suffering a credit downgrade immediately supply collateral to counterparties." Such events can become "a spiral that can lead to a corporate meltdown," he writes.

"The reinsurance and derivatives businesses are similar," Buffett said. "Like hell, both are easy to enter and impossible to exit."

Berkshire Hathaway shares added $US1689 to trade at $US63,389 in New York Stock Exchange composite trading yesterday. They have declined 13 per cent in the past year.

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