BBC NEWS

Buffett warns on investment 'time bomb'

> **Derivatives are financial weapons of mass destruction**
> Warren Buffett

The rapidly growing trade in derivatives poses a "mega-catastrophic risk" for the economy and most shares are still "too expensive", legendary investor Warren Buffett has warned.

The world's second-richest man made the comments in his famous and plain-spoken "annual letter to shareholders", excerpts of which have been published by Fortune magazine.

The derivatives market has exploded in recent years, with investment banks selling billions of dollars worth of these investments to clients as a way to off-load or manage market risk.

But Mr Buffett argues that such highly complex financial instruments are time bombs and "financial weapons of mass destruction" that could harm not only their buyers and sellers, but the whole economic system.

Contracts devised by 'madmen'

Derivatives are financial instruments that allow investors to speculate on the future price of, for example, commodities or shares - without buying the underlying investment.

> **Derivatives generate reported earnings that are often wildly overstated and based on estimates whose inaccuracy may not be exposed for many years**
> Warren Buffett

Derivates like futures, options and swaps were developed to allow investors hedge risks in financial markets - in effect buy insurance against market movements -, but have quickly become a means of investment in their own right.

Outstanding derivatives contracts - excluding those traded on exchanges such as the International Petroleum Exchange - are worth close to $85 trillion, according to the International Swaps and Derivatives Association.

Some derivatives contracts, Mr Buffett says, appear to have been devised by "madmen".

He warns that derivatives can push companies onto a "spiral that can lead to a corporate meltdown", like the demise of the notorious hedge fund Long-Term Capital Management in 1998.

Derivatives are like 'hell'

> **Large amounts of risk have become concentrated in the hands of relatively few derivatives dealers ... which can trigger serious systemic problems**
> Warren Buffett

Derivatives also pose a dangerous incentive for false accounting, Mr Buffett says.

The profits and losses from derivates deals are booked straight away, even though no actual money changes hand. In many cases the real costs hit companies only many years later.

This can result in nasty accounting errors. Some of them spring from "honest" optimism. But others are the result of "huge-scale fraud", and Mr Buffett points to the US energy market, which relied for most of its deals on derivatives trading and resulted in the collapse of Enron.

Berkshire Hathaway, the investment group led by Mr Buffett, is pulling out of the market, closing down the derivatives trading subsidiary it bought as part of a huge reinsurance company a few years ago.

In his letter Mr Buffett compares the derivatives business to "hell... easy to enter and almost impossible to exit", and predicts that it will take years to unwind the complex deals struck by its subsidiary General Re Securities.

Warren Buffett, dubbed "the sage of Omaha", from where he controls Berkshire Hathaway, is well-known for both his blunt assessments of the markets and the high returns he delivers to shareholders.

This year, he remains cool towards further share investments, despite the sharp correction in stock market values. Mr Buffett says this "dismal fact is testimony to the insanity of valuations reached during The Great Bubble".

Berkshire backyard barbecues

A good friend of Bill Gates, he famously refused to invest in technology shares during the boom years that came to a sudden end in March 2000. As a result, Berkshire was sitting pretty after the technology bubble burst.

In marked contrast to the hubris of former managers at fallen firms like Enron and WorldCom, Mr Buffett is known for his down-to-earth style, summoning shareholders not to glitzy hotels but "Berkshire backyard barbecues" and baseball games in out-of-the-way Omaha, Nebraska.

But his strategy of identifying undervalued companies with good management in unfashionable retail sectors or the insurance industry and investing in them for the long-term has produced spectacular returns.

During the past 37 years, the company has delivered an average annual return of 22.6%. Since 1965 the company's book value has gone up by 194,936%.

However in 2001, the last year for which detailed numbers are available, heavy losses in the insurance industry worldwide resulted in a $3.77bn loss at Berkshire Hathaway - the first loss in the firm's history under Warren Buffett.

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