Financial News

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Why is Buffett So Interested In The Railroad Industry?

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Christopher Hancock submits: Recently, Berkshire Hathaway disclosed its 10.9% stake in Burlington Northern Santa Fe (NYSE: BNI - News) worth US$3.4 billion. To no one's surprise, investors around the globe jumped on the Warren Buffett express. Burlington's share price rose 6.5% on the announcement.

And Buffett didn't stop there. Berkshire Hathaway confirmed it has also acquired stakes in two remaining North American railroads. The largest American railroads remaining are Union Pacific (NYSE: UNP - News), CSX (NYSE: CSX - News) and Norfolk Southern (NYSE: NSC - News). Our neighbors to the north offer Canadian National [TSE: CNR].

No one really knows why Warren Buffett fell in love with railroad investing all of a sudden. Burlington certainly carries Buffett-like characteristics: consistent earnings growth (22% annualised over five years), impressive margins and limited competition.

But none of these railroads typify your typical Benjamin Graham value play. The stock trades for more than three times book with limited liquidity and tangible debt.

So what was Warren Buffett thinking that drove Berkshire Hathaway onto the rails?

It's anyone's guess. But the prevailing consensus believes globalisation - specifically, moving the major staples of trade (things like coal, oil, cars and clothes - in other words, basic commodities and finished goods) from producer to consumer - is the long-term trend at play here.

I'll buy that.

It was about this time in 2002 that a rebirth in the tangible assets sector really began. Much of that growth can be directly attributed to the insatiable demand for raw materials that the developing giants China and India are now consuming.

These countries are still in the early stages of development. It takes about 30 years to go from an agrarian to an industrial society. China is about one-third of the way there. China will continue to import commodities to sustain this enormous transition. India will do the same.

Furthermore, the golden era of stocks (1982-2000) directed capital in about every investing avenue except natural resources and raw materials. Hence, limited demand caused a decrease in available supply.

Now the entire world can't get enough copper, zinc, lumber and oil. But bringing on new production takes time. Supply can't catch up with demand overnight. In fact, it's going to take quite some time, especially when you throw the consumption potential of India and China (37% of the world's population) into the mix. Consequently, commodities, the market for the essentials, will remain tight for the foreseeable future.

And commodity consumption won't be limited to emerging markets alone. Let's not forget that the United States has begun to embrace alternative energy. And the two greatest oil alternatives, coal and corn, are shipped by train.

So transport stocks like Burlington certainly play into this long-term trend. And considering that rising fuel prices affect trucks more than trains, this idea begins to make more and more sense.

But many feel it's too late. Many believe the upside is already priced in.

Well, that may be true.

You see, recently, Prudential, Bear Stearns and UBS all downgraded BNI to some type of peer perform/neutral rating. Most investors are now asking: was Buffett wrong?

The key to that last sentence is the word “investors”. Most individuals who buy and sell shares are traders, not investors. These are people looking for a quick buck. The type of action that reflects an attitude more suited for the Las Vegas Strip, not the undying, underappreciated sex appeal attached to the US$500 monthly deposit in the retirement fund.

Without becoming too insipidly philosophical here, let me quickly add this. Blaise Pascal once said: “Most of men’s problems arise from their inability to sit quietly and alone”.

That’s a fair point. Actually, that’s a very good point.

It takes a rare soul to patiently sit on a US$32 billion Korean steel stock when the daily headlines of even the most conservative publications saturate our brains with tales of highflying hedge fund managers making upward of US$1 billion annually or A-list celebrities with nothing more than a high school degree receiving a US$20 million payday.

But take solace in this. As Max Ehrmann wrote: “If you compare yourself with others, you may become vain and bitter; for always there will be greater and lesser persons than yourself. Enjoy your achievements as well as your plans.”

Shipping is, and will remain, irreplaceable on the world stage. We can’t live without it. It won’t be replaced. It’s been around for centuries. Until we reach a stage of technological innovation in which the major staples of trade - things like coal, oil, cars, the finished products that fill Wal-Mart stores - can be disassembled one molecule at a time and instantaneously beamed to another location, our current means for commerce will remain the most efficient.

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