

Warren Buffett's Question and Answer Session with Harvard Business School Students

12/22/2005

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Buffett's Introduction

- Ground rules for the Q&A session
 - I'm willing to talk about anything that you're interested in – politics, business, philanthropic issues, etc. The tougher the questions, the more interesting.
 - I'll discuss anything except for what we're buying and selling. That's off limits.
- Nebraska Furniture Mart (NFM) – The Story of Rose Blumkin, the Founder of the Mart
 - When she walked out of Russia, she couldn't speak a word of English. She spent 16 years selling used clothing to pay for bringing her other family members over to the U.S. and in the process saved \$500 doing this.
 - Rose learned English from her granddaughter who came home and taught her the words she learned in elementary school.
 - When she started the Mart, she had a real estate disadvantage, a buying disadvantage, a credit disadvantage, an educational disadvantage as well as a reputation disadvantage. Despite these obstacles, she outmaneuvered and outcompeted everyone else, and built the largest furniture business in the country
 - She was smart, but she was smarter about defining her circle of competence. She knew furniture and carpet, but not many other things. She knew where she was playing with an advantage and where she wasn't, and she stuck to what she knew.
 - In 1937, she started with \$500 of paid-in capital, and now the business has \$700MM in revenues between the different stores.
 - Rose lived three blocks from the store and kept price tags on her belongings in her house because it made her feel like she was in her store, which made her more comfortable.
 - In 1983, Mrs. B was 89, and she and her four children each owned 20% of the business. Louie worked in the store and ran it. However, as long as Mrs. B was alive, she was the boss. She was worried that in the future some of the children would want to cash in and others might not.
 - Warren heard she wanted to sell her business and the sale process that ensued was remarkably simple by today's Wall Street norms:
 - Warren sent a short letter to Mrs. B and family – Berkshire has long admired your business...and proposes to purchase it.
 - Diligence Requests: Give us your tax return. Tell us you don't owe anything else against the property.
 - Final sale contract was a page and a quarter vs. the huge volume of papers used today on Wall Street for closing deals.
 - Total legal and accounting fees were \$1,400. He never tells that part of the story at law schools.
 - "Take care of thy shop and it will take care of thee." Ben Franklin – but that was Mrs. B.

- Louie, her son, went to WWII, and he and Mrs. B corresponded regularly dreaming about what they would create.
- Mrs. B didn't know debits from credits, but she knew what they were intuitively.
- If she was told dimensions of a room, she could tell you the square inches of carpet required and what it would cost.
- Warren said she was a combination of a peasant and a genius.
- Mrs. B never went to school a day in her life. Warren told her she was the only person who didn't go to kindergarten who has an honorary PhD (from NYU).
- Keys to success:
 - Keep costs down.
 - Sell what people want to buy.
 - Work hard.
- We've bought business after business like the Mart.
- Flight Safety is another example
 - Al Ueltschi started Flight Safety with only \$10K and now has \$1B of Berkshire stock.
 - Al believes in producing safer pilots. It's a passion for Al, and he built a fabulously successful business.
 - Warren met him for a hamburger and cherry coke at Skadden's offices. They had a deal in about an hour.
- Value of an HBS education: It won't hurt you to have an HBS education, but the keys to success can be learned elsewhere.
- Advice on how to do business: Find people you like and are capable, and things will work out.
- Charlie's hearing loss...or not
 - Charlie Munger, Warren's long-time partner, is going to be 82 on Jan 1st (2006). Warren was worried Charlie was losing his hearing. He asked his doctor how to test his suspicion, and his doctor recommended that he ask Charlie a question from across his office. If Charlie didn't respond, the doctor recommended that Warren ask the question again when he was halfway across the room. If this still didn't work, the doctor recommended that he stand right next to Charlie and ask the question again.
 - Warren, taking his doctor's advice, tried this. He asked Charlie, "What do you think about buying Microsoft at \$26?" Charlie did not respond. Warren then tried again from halfway across the room, but still no response. So Warren stood right next to him and asked the question again.
 - Finally, Charlie responded, "For the third time, yes."

What do you think is your single most important attribute that has contributed to your success as an investor? Can this be learned?

- Warren read Ben Graham's book, The Intelligent Investor, at age 19.
 - He feels lucky to have found the book.
 - Warren had been fooling around with stocks, but he didn't know how to invest. He bought his first stock at 11, and he kicks himself for not starting earlier.
 - At first, he was into technical analysis. He read anything he could about stock investing, but he didn't have a philosophy.
 - Graham's book gave him the framework for approaching stocks.
- Warren's advice was that you don't need to be a genius to do well in investing, but you do need the right temperament.

- If you have an IQ of 170, you can sell 45 points to someone else and still do well in securities.
- He said it's not clear how much of temperament is innate and how much can be learned.
- What's critical to success in investing is the ability to think independently, which is different from just being a contrarian.
- Quoting Graham, "You're neither right nor wrong because people agree with you. You are right because of your judgment."
- Be disciplined.
 - If everyone limited their investments to a punch card with 20 punches, they would all do better than they do today.
 - People get convinced that they have to be doing something in investing at all times.
 - Liquidity with stocks is an enormous plus but most people turn it into a negative.
 - Warren and Charlie have made most of (or all) of their money by being right about a business and sitting on it.
- The three most important lessons from The Intelligent Investor
 - Think of a stock as a part of a business.
 - A stock is not simply an item with a ticker symbol and past movements.
 - If you're right about the business, then you'll be right about the stock.
 - Chicken tracks in the past don't predict where chicken tracks will go next.
 - How to think about the market.
 - The market is there to serve you and not to instruct you.
 - Take advantage of the market when you disagree with what it's telling you.
 - The market is a game where thousands of companies are offered every day at various prices.
 - Graham describes the market as a manic depressive partner named Mr. Market who will buy your holdings out or will sell you additional interests every day.
 - If you look at thousands of opportunities with a crazy partner, you will have opportunities to get rich.
 - It's common for prices to change by 50% or more in a year for some securities. Huge changes in prices like this do not occur in other fields such as farming, real estate, energy, etc.
 - Graham provided him with a framework for dealing with the market.
 - Margin of safety
 - Don't buy things you think are worth \$1 for 99 cents.
 - Wait for big discrepancies between price and value.
 - You need to have the attitude that you will not play until the opportunity is really extraordinary.
 - What's important is buying a good business at a good price. You can skip the rest.

You talk about your circle of competence and how you are careful not to step out of it. With your success over the years, have you felt the temptation to try to "expand the circle"?

- His circle of competence does expand.
- If you are interested in the subject of business, you will be interested in learning other things related to business.
- Tom Watson senior (IBM) once said, "I'm no genius. I'm smart in spots." One can expand the number of spots over time.

- Buying See's Candy allowed him to learn more about consumer goods.
- Charlie's and Warren's circles are much wider now than in the past.
- Their largest problem is that "needle-moving" ideas have become harder to find.
- When he started, any investment in the world was an opportunity.
- Now his circle is larger, but there are fewer things within the circle that can make a difference.
- He thinks about business constantly.
- We all know that Wrigley's chewing gum will always be a great business but that doesn't mean it's a great stock.
 - Snicker's candy bar has been the #1 candy bar for 40 years. People aren't going to change. You don't experiment with stuff you put in your mouth for a 5-cent difference in price.
 - He looks for products with moats around their brands.
- Gillette has 70% of the market for razors and blades.
 - It's been 100 years since the founder came up with the product. Lots of people make razors, but haven't been able to displace Gillette as the market leader.
 - Men don't like to change how they shave. It's the only creative thing they do all day. Men don't experiment. They buy the same fashions over and over.
 - Gillette became the friend of the American male as he grew up.
 - Gillette had a low share of the business in 1939. NBC offered advertising for the whole World Series, and Gillette decided to spend their whole advertising budget on the series.
 - The Series was only 4 out of a possible 7 games so they thought they got short end of the stick. But this cemented Gillette's relationship with the male consumer, and was the beginning of their enduring competitive advantage.
 - Warren says he now counts men's faces who need a shave to fall asleep. He used to count women's legs, but that didn't help him sleep.
- See's Candy
 - Before he bought it, the only question he asked of the sellers was, "What hold does this have on consumers? Can we charge another dime without scaring off consumers?"
 - A man doesn't go home on Valentine's Day having bought a cheaper brand of candy.
 - If your sweetheart kisses you after giving her See's candy, then you don't switch brands.
 - A competitor cannot damage See's in California. They have tried, but have not been successful.
 - A billionaire tried, and named his brand after his mother. Unfortunately the guy wasn't likely to shut the business down very easily since his mother wouldn't have been happy, but this competitor still didn't displace See's.
 - Candy bars don't travel, and they are not a global product or even a national product.
 - See's has tried to sell its candy on the East Coast, but there are different regional preferences.
 - Why does Dr. Pepper have 60x the share in Dallas that it does in Boston? This doesn't make sense, but it's the reality of the soft drink market.
 - Everyone in California has something in their mind about See's.
 - Can't get RC Cola into people's minds, but they do have Coca Cola in their minds.
 - They lose a lot of money by being at Disney and the Olympics, but these are associated with happiness and reinforces the Coke brand.
 - Extra penny on a can of coke is worth \$13MM a day or \$4B a year

In early October, the investment world lost Bill Ruane of the Sequoia Fund. Looking ahead, who do you think will be the "intelligent investors" that people will write about 50 years from now? Likewise, who are some investors that you have the highest respect for?

- Bill and Warren took Ben's class together (Julian Robertson was also in their class).
- Bill and Warren became fast friends during Ben's seminar.
- If Warren can look at a person's 10-year record and what investments they made, he can get a pretty good understanding of their potential as an investor.
- He's often asked who the next great investor is going to be. There will be some, and they will do it like Bill did.
- Bill loved making money for other people, and he liked giving it away.
- He set up the Sequoia Fund to take care of Buffet's partners as Warren was going out of business. Bill was a terrific friend.
- If Warren dies tonight, the directors of Berkshire know who they will put in place as CEO. Lou Simpson will run the money, but the directors will need to identify someone to take over. It will be difficult.
- Gates has run money very well.
- Great money managers need to have the right temperament, be reasonably bright and be very honest.
- He doesn't have names.
- One manager he can think of gave him an idea that was like shooting fish in a barrel.
 - That guy manages money very well but he's not taking money now.

How have unforeseen risks changed the way he thinks about investing?

- If there were two nuclear explosions now, it would change the world in a major way and it is possible that this could occur.
- The three factors necessary to do harm are (a) intent, (b) knowledge and (c) materials.
 - Lots of people want to do harm to us (intent) and a small number have the knowledge.
 - The limiting factor in doing damage is materials and deliverability.
 - Graham Allison wrote a very good book on this.
- The number of people who want to harm us is huge.
- Who has used the atomic bomb in the past? The most prosperous country in the world. Prosperity doesn't impact intent. Intent will be there.
- A millennium ago, intent resulted in throwing rocks. Now it's much more deadly.
- We are not a better class of human beings. Psychotics are probably same percentage and now there are many more of them as the population has grown.
- The knowledge is way more widespread than it was.
- Berkshire is always prepared for something cataclysmic.
- Long Term Capital Management and many others have learned that 10 minutes of the wrong factors can undo everything you've prepared for.
- Berkshire is prepared for the stock exchange closing.
 - This happened after 1914 and for a few days after 9/11.

- There is a very high probability that a major nuclear, biological or chemical incident will happen somewhere. In fact, Warren believes it will happen somewhere. This doesn't change his investment strategy, but it might make him a little more cautious.
- Long Term Capital Management
 - The partners at LTCM believed they failed because of a six-sigma event.
 - But Warren believes it was human panic and error. The same problem that brought down LTCM caused the problems with the Northern Pacific railroad in 1903.
 - LTCM was betting on spread convergence. For instance, they would take two obligations of the U.S. government such as two 30-year bonds, one of which matured in 30 years and one which matured in 29.5 years. At the time the spread between the bonds was 30 basis points. That is not an efficient market. Their problems arose because many people were playing in the same game, and betting the spread would converge. When the music stopped, the spread went the other way.
- Efficient markets break down periodically.
 - The market is not purely mathematical.
 - People who do not protect themselves against the exchange closing or other extreme events are more exposed to risks than they realize or care to admit
- Incidentally, if Hitler hadn't been so anti-Semitic, he probably would have won.
 - His best scientists came to the US and were the reason we got the bomb.

Has the proliferation of hedge funds, venture capital outfits and the amount of money in private equity made the job of the "intelligent investor" more complicated? Are opportunities made more scarce or plentiful because of these factors?

- Markets everywhere follow three stages -- innovators, imitators and swarming incompetents.
- We now have \$1 trillion in hedge funds. Opportunities are discovered, people swarm in and the opportunity is competed away.
- A trillion dollars in the hands of smart people leads to a lot less opportunity.
- Huge pools of money doing the same thing Warren is doing makes it more difficult for him.
- Berkshire has an advantage in buying from people who don't want to auction off their business. Family businesses are not a piece of meat. Often a family has personal reasons to sell, but they do not want the business to leave the family. Therefore selling to Berkshire can provide a solution for them.
- Selling families have a choice. Berkshire is like the Metropolitan Museum of Art, or they can sell their businesses to a pawn shop operator. The pawn shop operator (private equity firm) will dress it up and resell it. Do you want the guy in the raincoat or do you want Warren?
- Mrs. B felt this way. Her business wasn't a piece of meat.
 - As a side story, Mrs. B quit at age 97 when she got mad at her family over how they were handling the carpet business. She then opened another store and competed with NFM/Berkshire.
 - Two years later, she called Warren and said she had made a mistake.
 - This time Warren asked for and got a 10-year non-compete. She worked until 103 and died at 104. Warren is still glad he had the non-compete even after she died.
- He made five deals this year and not one has been at an auction.
 - Two of them had higher bids from private equity shops.
 - One was Forest River (makes recreational vehicles).

- Warren received a fax about the company, and indicated his interest the next day. He asked for the audits and other figures.
 - Warren called next day after getting the documents, and offered a price.
 - The founder came to Omaha shortly thereafter, and they struck a deal in 15 minutes.
 - The business earns \$100MM pretax. Warren asked the founder what salary he wanted. He told the founder, “You name a salary that makes you feel good.” The founder thought for a minute. He said, “I looked at the proxy and I saw you make a \$100K a year. I wouldn’t want to make more than you.”
 - They’ve spoken once since then. Forest River is his baby. The founder has opened new plants, and he oversees the building of them himself.
 - It’s still his business. He mails Warren money, but it’s his business.
 - He doesn’t need Warren’s advice. What he wants to do is the same thing Warren wants to do: They both want to keep painting their own paintings.
- Berkshire will continue to be able to buy businesses like these.
 - Private equity and hedge funds will create opportunities for Berkshire. There will be another LTCM-like event.
 - LTCM
 - Warren got call on Sunday night from Eric Rosenfeld asking if he wanted to take on \$6B of arbitrage positions.
 - Larry Hillenbrand came out to see him two weeks later.
 - Warren put in a bid. He was on a trip, and said that’s why his bid didn’t go through.
 - The more venturesome other people get, the more opportunities are created.

Do you think there will be a shake-up in the hedge fund industry, and if so, which firms will be first to go and which firms will likely survive?

- It always seems like there is one more dance left.
- Seeing dumb people making money drives people crazy.
- It’s like Cinderella at the Ball. Everyone knows everything turns to pumpkins and mice at midnight, but they are in a room with no clocks.
- People think, “I’ll do this just a bit longer and I’ll get out just in time.”
- In the investment world, there’s no clock on the wall.
- Smart people outsmart themselves.
- At times, people knew the accounting was phony, but they thought it would hold just a bit longer. A crook will keep on cheating/lying.
- The feeling that you’ll know when the party will end is very strong.
- The day the Nasdaq peaked, Berkshire hit a low. This was the day before Berkshire’s annual report was filed. Warren wrote something like the attempt to time the market is the apple in the Garden of Eden. So much money makes it so tempting.
- Barton Biggs – very smart guy – has a new book Warren recommends.

What are the characteristics of the firms that will survive when a big blowup occurs?

- Berkshire will survive.
- Cannot play at the edge.
- Warren has a phobia regarding borrowed money.

- Warren might borrow through an insurance form with no due dates and no covenants, but otherwise debt is like a loaded gun.

If we were taking your investing class, what would be the key takeaways you would want us to learn from the lesson on calculating intrinsic value? We've taken finance classes, but share your lack of confidence in the usefulness of CAPM.

- How Warren finds investment opportunities.
 - Warren looks for opportunities that fit within his circle of competence, and he looks for good businesses.
 - Quoted Peter Lynch: “Look for a business that an idiot can run, because sooner or later one will.”
 - Warren loves good businesses at fair prices.
- Warren would like to drive a stake in the efficient market theory.
- He came out to Omaha to make money. He didn't expect anyone to tell him how to get rich. He decided the logical first step would be to read through the Moody's manuals to find ideas.
- Moody's had these four big books covering different industries and he read through every manual twice. When reading the manuals, he was looking for 7-footers.
- He also would read annual reports to look for opportunities.
- Western Insurance Securities.
 - He had never heard of the company when he came across it.
 - Earnings in 1949 were \$21.46 per share and \$29 the next year. The price range for the stock was \$3-\$13 over the last year.
 - Efficient market theorists would say there's nothing wrong with that.
 - The company was required to file insurance reports with the state so he looked at the reports and he talked to some of the company's agents.
 - He found that investors just didn't realize the potential of the company.
 - An opportunity of this size couldn't do much for his net worth now, but buying stocks at half price still works.
- Another insurance example
 - The company's stock was selling for \$28 and it had earned \$29 a share the previous year.
 - The company turned out to be one of the most profitable fire insurance companies in the U.S., and was located only a block away from Warren.
 - The manager of the operation fed his good insurance business into this one small company, which he controlled.
 - There is nothing efficient about a market in which this opportunity existed.
- Kansas City Life
 - Warren went to visit the local insurance agent and asked a series of questions.
 - Warren: Is there any better company? Agent: No
 - Warren: Do you have some of their insurance? Agent: Yes, my whole family is insured by them.
 - Warren pointed out to the agent that his company's stock was selling at 3x earnings. The agent didn't have any interest in buying stock in his company from Warren. Warren knew he shouldn't be a salesman at that point.
- Union Street Railroad
 - The company had \$70 in cash on its balance sheet, which was not fully reflected in its stock price. Warren executed a profitable trade based on this pricing discrepancy.

- Warren said he has never learned anything by reading Wall Street reports. He found out about this opportunity by reading the public documents.
- He believes all the info an investor needs is in the public documents.
- Korean stocks
 - Citicorp sent him a manual on Korean stocks.
 - Within 5 or 6 hours, and found 20 stocks selling at 2 or 3x earnings with strong balance sheets.
 - Korea rebuilt itself in a big way post-1998. Companies overbuilt their balance sheets.
 - Daehan Flour Mills – 15,000 won/year earning power. Stock was selling at 2 and change times earnings.
 - Warren’s strategy was to buy the securities of 20 companies thereby spreading his risk. Some of the companies will be run by crooks.
 - He doesn’t know any of the companies and he’s never been to Korea before. Information on these companies is available over the Internet in English.
 - Also, the won has strengthened, which was an added bonus.
 - The investment presented an opportunity to make 150% at which point the stocks would still only be selling at 7 or 8x.
 - It’s ridiculous to say there’s an efficient market.
 - They put \$100MM into this by doing very little work.
- Bob Rubin’s book is a great book

What is your view on the strategy of shorting individual stocks?

- Warren has done a fair amount of shorting over his lifetime, and he’s also invested in a lot of arbitrage positions.
- If an investor is smart enough to make money in shorts (100% upside and unlimited downside), he/she can probably make a lot more money on the long side.
- In shorting, management is working against you, and is usually willing to lie quarter after quarter. Investors are dealing with stock promoters who work against them.
- Shorting is just not a smart game. All of the math is for you on the long side, and all of the math is against you on the short side.
- He has had 100 short ideas, and he’s been right on most of them. But it’s still hard to make money.
- Investors should do a little of it in life to have the experience but it’s not pleasant. Investors think about their shorts much more than their longs.
- In high school, Warren described himself as a “pain in the ass”. All of his teachers owned AT&T and had most of their retirement savings in the stock. He shorted the stock and then showed them the transaction certificates to cause them a little heartburn.

How do you separate good companies with weak capital structures or those in deep industry cycles from companies that are simply bad?

- Great companies can get into great trouble through debt, scandal, or who knows how.
- Warren told his partners that he wanted to go beyond his limit for a single investment to invest in American Express. None of his partners left, and Warren had all his money in his fund.
- American express suffered a scandal, but consumer habits hadn’t changed. The franchise value of the company had not been damaged.

- GEICO had a similar problem. The company had a removable tumor, and he knew it would still be a great athlete after the restructuring.
- Investors will see great companies occasionally get hit by some negative event. As long as these problems are not fatal (and management teams are honest), there will be great opportunities.

Getting started and establishing a reputation

- Ohio Town
 - Some time after Warren returned to Omaha, he found a town for sale in Ohio. The government had built it, and wanted to sell it.
 - Warren went all of over Omaha to try to raise the money to purchase the town. He needed a \$150K down payment, and only had \$10K himself.
 - He wasn't able to raise the funds, and he couldn't sell the idea.
- GEICO
 - The first stock he started selling was GEICO.
 - Warren tried to sell it to insurance salesmen, which didn't work.
- He went to work for Graham in 1954. Afterwards he felt like he had all the money he needed. He had no idea he would start a partnership.
- Starting his own business
 - Warren would not tell his partners (and family) what he was doing because he didn't want the pressure that would have caused.
 - It was difficult to get started. Graham referred some investors to him, and over time he built up a track record.
 - He was having a great time with everything he did.
 - Also, he lived the same way he did then as now. We [the HBS students] live the same way he does. We drive the same sort of cars. The only difference is when he travels long distances.
- General Advice
 - We live better than Rockefeller lived. We all live better because the world is better.
 - Health is 95% of success.
 - There once was a Wall Streeter who missed two years of bonuses. To save money, he suggested to his wife that if she learned to make dinner, they could get rid of the cook. She responded, "And if you learn to make love, we can get rid of the gardener."

In your letters you mention that stock returns approximate ROE over long periods of time, even if the entry price is apparently very high. If this is the case, why do you also say that there are many good businesses, but few at a good price?"

- Interest rates are the yardstick everything is measured against.
- Aesop – a bird in hand is worth two in the bush. An investor needs to be sure birds are there and needs to know when he'll get them.
- If you are in your circle of competence, you can be more sure that you'll get the birds.
- If you can't be sure about getting the birds, then just sit in treasuries.
- The tough thing for Berkshire is that interest rates are so low now.
- Warren and Charlie will not drop their discount rate below a certain level (based on terribly easy money from the Fed), but will adjust it upward.

- They don't measure buying businesses against a 4.75% long bond, but they are still impacted by the 4.75% long bond.
- They are plenty conscious of interest rates.

The charitable foundation that is set to be the main beneficiary of your personal holdings of BRK stock will instantly become the most well-funded institution in the world. What are your hopes for its impact on our society?

- Every share Warren owns will go to charity.
- For a long time he felt society was better served by him compounding his money instead of giving it away.
- He's now thinking more about giving something away now than he used to.
- His guess is he's no longer doing society a favor by compounding.
- He has six trustees for his foundation, and he has written them a seven-page letter with his philanthropic philosophy, which is like his investing philosophy.
- He has told his trustees to do whatever they think will be best for society.
 - This includes things that governments or most foundations will not do.
 - He has told his trustees to pursue whatever paths the social benefits outweigh the costs of solving.
 - He has also told them not to worry about what others think.
 - He expects them to fail.
 - He said the focus should be on something where there's a significant chance of failure.
 - The main thing is to have high-grade, smart people who are independent thinkers. Most of trustees are women.
 - Women's issues are enormously important and underserved. Warren believes that he is the product of prejudice. Women only had four choices. Half the talent pool in the country worked in these four choices. He got the quality education he did because women were repressed. It's shocking to him that the gender inequality still goes on today.
 - He wants to tackle the outrages of society.
 - He thought it might happen at his death but it might happen sooner.
 - This could involve anything on the nuclear, chemical and biological threat that society faces.
- He likes what Bill and Melinda Gates are doing
 - They will spend a \$1B a year, and are focusing on how to save the most lives.
 - It's the most rational and best-executed foundation policy he's ever seen.
 - They have thought this through and have put their hearts and heads into this. They have great analytical minds.
 - He admires them the most.