Whitney Tilson's 2006 Berkshire Hathaway Annual Meeting Notes

May 6, 2006

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***Note**: This is not a transcript. No recording devices were allowed at the meeting, so this is based on many hours of rapid typing, combined with my memory. I have reorganized the content of the meeting by subject area. All quotes are Buffett's, unless otherwise noted. Words in [brackets] are my comments, edits or, when I missed something, my best guess of what was said.*

For my columns and notes on previous Berkshire and Wesco meetings, click here.

OPENING REMARKS

[The Berkshire meeting always starts with a movie. In this year's movie, actress Jamie Lee Curtis lusted after Munger in one funny segment as did, in another, Nicollette Sheridan, the blond bombshell who plays Edie Britt in *Desperate Housewives*. After the movie finished, Buffett commented:] You may be puzzled why in the movie Charlie always gets the girl. I think it's due to the Anna Nicole Smith Rule: When choosing between two old rich guys, pick the older one. [Laughter]

Berkshire's Q1 Results

[Click here to read the Q1 10-Q.]

[There was a slide on the screen that showed the year-over-year Q1 operating profits from Berkshire's four sources of earnings.] Things worked out pretty well in the first quarter for all of them. I would caution you that, in our insurance underwriting, our worst quarter would normally be in the third quarter, with lesser exposure in the fourth quarter. We write a lot of catastrophe insurance. Earthquakes aren't seasonal, but hurricanes are.

If we write a one-year insurance policy with $1 million of premium, we recognize $250,000 each quarter. In our view, that's not proper accounting, but we're required to do it this way [by this, Buffett means that, logically, the premium income should be recognized and flow through the financial statements during the quarters in which the risk occurs, not evenly throughout the year, as GAAP requires]. You can't take our insurance results in a benign quarter and extrapolate them.

Nevertheless, it was a very good quarter. GEICO's growth was better than that of any of its competitors, Gen Re did well, as did our smaller companies. Things are generally working very well in all four sectors. But five years from now, nobody will remember whether Q1 this year was any good…

Iscar Acquisition

…But what's really important is we acquired a large, extremely well managed company called Iscar. Last October, I'd never heard of this company, but then I got a 1 ½ page letter from Eitan [pronounced "Ay-tohn"] Wertheimer. Sometimes I get a letter and a person's character and intellect jump off the page at me. So I met Eitan and his top managers in Omaha. They subsequently met Charlie. This all came to fruition yesterday when we signed the deal. [Click here to read the press release.]

As hard as this is to believe, Charlie is as enthusiastic about this as I am.

Munger: This company rose from very modest beginnings to be the best company in its field in the world. It's not the largest, but that leaves them something to do. [Laughter] The quality of the people in this company is off the chart – and they're young. This is a real quality enterprise and we can learn a lot from them. [According to a friend, at another venue Charlie said that a person like Eitan Wertheimer comes along "every 200-300 million people."]

Buffett: I'd like Eitan and his two managers to stand up. Jacob Harpaz is President and CEO. Danny Goldman is CFO. Take a good look at these people – they're going to do very, very well for you.

Eitan's Remarks

Eitan Wertheimer: It's a beautiful day in Omaha. We bring our family to a new home. I bring more than 5,000 people here, and their families. For years, we weren't sure what to do [in terms of monetizing our ownership of Iscar]. Then someone came to me and said, "Have you heard of Berkshire?" We found that Berkshire, like us, is a family company with a strong culture. And Berkshire is run by young people who we'd like to work with for 20-25 years. [Laughter] We had a very interesting lesson from Warren and then Charlie – and we survived! [More laughter]

I represent a big family. We make cutting tools and molds for cars, washing machines, the mold for Coke bottles, etc. I want to thank our customers, not only for buying from us but for trying new things. We try to stay competitive...

This is Jacob. In reality, my job is not to disturb him. Jacob gently fired me many years ago.

The company is 34 years old. We're in 61 countries around the world. We have to fulfill a lot of expectations and work very hard to make sure everyone in this room is glad that we joined the family. Let's be successful and look to the future. Every year, I look forward to coming to Omaha when the fields are green and the days get longer.

[At this point, on the main screen, there was a 10-15 minute movie about Iscar and its many worldwide subsidiaries, products and markets. The company makes all kinds of highly specialized cutting tools that are used in a wide range of industries, including automobiles and aerospace. The movie also touched on the history of the company, which was founded in the mid-1950s by Stef Wertheimer, Eitan's father, who is currently honorary Chairman.]

Buffett: This is an important acquisition. We paid $4 billion for 80% of the company. It's the first business we've purchased that is based outside the U.S., though many we've purchased have major operations outside the U.S.

I think you'll look back at this in 5 to 10 years as a very significant event in Berkshire's history.

[This was, in effect, a very public wedding: both sides making vows of lifelong love, loyalty and commitment, in front of a vast number of friends, family and witnesses. In addition, the press in Israel has been remarkable. Here's an excerpt from one article:

> Prime Minister Ehud Olmert called Eitan Wertheimer last night to congratulate him on the sale. "It's terrific tidings and a great gift to the State of Israel," Olmert said. "We tip our hat to you, personally and in the name of the whole country."
>
> Eitan Wertheimer said selling the company for him is "lighting an economic torch," just as his father Stef lit a torch on Independence Day. According to him, Buffett's expression of faith is an important declaration for the country, "and just as they talked about the Balfour Declaration – now they'll talk about the Buffett Declaration." Olmert will speak with Buffett today. A government source said Olmert was indirectly involved in the deal.

A friend observed this and (correctly) commented:

> The huge edge Buffett has built is represented in the phenomenal global celebration of the Iscar acquisition.
>
> Eitan Wertheimer is now a hero and favored son of the state of Israel and, in selling his company to Buffett, he has achieved a phenomenal stature relative to his peers. Selling to Bain Capital would have not gotten anywhere this level of press, nor generated a call from the Prime Minister.
>
> Is this level of instant global recognition worth offering Mr. Buffett a price he can't refuse? You betcha! Watch the global competition to be the next 'Omaha Idol' heat right up!! What an edge!]

Thoughts on Acquisitions

It's important to note that in this world where many businesses get dressed up and auctioned off, we occasionally hear from people who consider their business too important to auction off. We don't participate in auctions. I can't recall buying a business at auction, can you Charlie?

Munger: I can't remember one.

Buffett: People who won't put their business up for auction like a piece of meat and care about the home in which their business resides are the type of people we want to be partners with. It says something very important about how much they care about their business, their customers and their employees. We've acquired a number of businesses like this in the past couple of years and the crowning one is Iscar. I'm going to Israel in September to see if there are any more girls like Iscar there.

[I think the Iscar acquisition is fantastic news for three reasons:

1. It's big – at $4 billion, it's the 3rd-largest deal Buffett has ever done);
2. It appears to be an awesome business. According to an article in an Israeli newspaper, Iscar was valued at $800 million in 1997, so it's increased in value by more than 6x in nine years (that's 22.6% compounded annually); and
3. It's the first business Buffett's ever bought that is headquartered overseas. This is a huge step forward in expanding his hunting ground to the entire world for the "elephants" he's seeking. Having lived and traveled all over the world, I know that there are many fabulous, privately held businesses like Iscar, and Berkshire is the perfect buyer for many of them.]

International Attendees at the Berkshire Meeting

This year we had 550 requests for tickets [to a reception after the meeting] from international visitors, versus 380 last year.

[After these opening remarks, Buffett and Munger opened up the microphones for questions from shareholders for the rest of the day.]

COMMENTS ON BERKSHIRE HATHAWAY

Berkshire's Annual Report

In it, we tell you everything I'd want to know if our positions were reversed. If I had 100% of my net worth in the stock and had been on a desert island for a year, it has everything I'd want to know. We don't leave anything out. You could drown people in information that doesn't make much difference. We explain it in the way we think about it. It's the report I would make to Charlie or he'd make to me if one of us were running the business and the other were inactive.

How to Value Berkshire

I'd think about what's there, what are they trying to do, what's it worth if they don't succeed in deploying additional capital, and what it's worth if they do. What are the resources available to keep adding to the collection of businesses? I think you'll find the information [in the annual report] that you need to evaluate Berkshire. Don't take it out to 4 decimal places. If Charlie and I had to write down a number, it would be different but in the same ballpark.

What Berkshire will be worth 10 years from now will depend on earnings, the quality of those earnings and the liquid assets we have. We keep working on it, but we're so big. There's no way in the world we can replicate the past, but hopefully we do a reasonable job.

Munger: Quickly get rid of the no-brainer decisions. Just go through the cash and investments, which are easy to value. The insurance operation is very interesting and look at the way the cash is deployed.

Deploying Berkshire's Cash

Buffett: I don't think we'll hit any home runs under any circumstances.

A normal level of cash for Berkshire might be about $10 billion. Because of the catastrophe-insurance business we're in, we don't scrape the bottom of the barrel [in terms of cash reserves]. We might temporarily dip below $10 billion – about one year's worth of earnings, incidentally – but we don't need anything like $40 billion. We'd be much happier if we had the excess invested in things we love.

I think, according to the 10-Q, we have $37 billion in cash [$37.675 billion, to be precise], not counting the finance businesses, and we spent $4 billion on Iscar and we're spending on some other things.

We'd like very much to spend down to $10 billion and we spend all of our time on this. We have one idea at present that could take up to $15 billion of cash, but it's a low probability. We'll get more choices in the utility area.

While we don't like having excess cash, we like doing dumb deals even less because we're stuck with them forever. You're right that we should be uncomfortable that we have this cash, but [the alternative of doing bad deals is far worse].

I think it's likely, but far from certain, that three years from now we will have significantly less cash and hopefully far more earnings power. We *love* having $4 billion in Iscar rather than it sitting around in short-term bonds. You're right to keep jabbing us, but we jab ourselves. Neither one of us likes having cash.

We're the biggest player in the world in catastrophe insurance, and people come to us because we're so liquid, but we don't need so much cash.

We spent $3.5 billion at the Berkshire level in PacifiCorp. Come back next year and I hope we have less cash.

Munger: Compare Berkshire 10 years ago to today. Despite much difficulty putting cash to work, we've bought a lot of great things and we're not altogether gloomy about how things are going. [Translation: He's doing handsprings about how Berkshire is doing!]

More on Acquisitions

Russell is in process – it'll probably be a couple of months before completion. I described the Business Wire acquisition in the annual report. I got a letter from Cathy [Baron Tamraz, CEO of Business Wire]. [Regarding the purchase of GE's Medical Protective Corporation,] I knew [GE CEO Jeff] Immelt wanted to shed some insurance assets and I suggested we'd be interested in that part of it, so we talked and made a deal.

One thing we haven't done is participate in auctions. I get books occasionally and the projections are just plain silly. Maybe that's why they don't sign them. I'd love to make a bet with the investment bankers about whether the companies achieve the earnings in the pitch books.

The calls we want to get are from people who care about their business, who for tax or family-ownership reasons want to sell to us. They're looking to change the ownership structure, not the operating personality and culture of the company they care deeply about.

The owners of Iscar are keeping 19% [I think he meant 20%]. They think [Berkshire] is the best place for their business and their people, and where they'll have the most opportunity to grow. I don't know how many stories you read about a $4 billion deal that doesn't say anything about an investment banker on either side.

Munger: The interesting thing about it to me is the mindset. With all these "helpers" running around, they talk about doing deals. We talk about welcoming partners. The guy doing deals, he wants to do a deal and then unwind it in the near future. It's totally opposite for us. We like to build lasting relationships. I think our system will work better in the long term than flipping deals.

I think there are so many of them [helpers] that they'll get in each other's way. I don't think they'll make enough money to meet their expectations, by flipping, flipping, flipping.

Buffett: By charging fees, fees, fees. [Laughter]

Munger: Warren talked to guy at an investment bank and asked how they made their money. He said, "Off the top, off the bottom, off both sides and in the middle." [Laughter]

Even More on Acquisitions and a Critique of Buyout Firms

[A shareholder asked if he'd be interested in buying Oriental Trading Company, a direct marketer of novelties and gift items, which is based in Omaha.] I looked at Oriental Trading a few years ago. I didn't know it was for sale again. I don't know, but I suspect some private group bought it and is now selling it. We see that all the time. They invariably try to sell it quickly to a strategic buyer, which is another way of saying someone who pays too much. Anytime someone calls me and says we'd be a logical strategic buyer, I hang up the phone faster than Charlie would.

The idea that we're going to find a business to buy from a guy who's been thinking from the moment he bought only about how he's going to spruce it up and get out, is very low. It's Fund A selling to Fund B to Fund C. The irony is that the same pension fund may be invested in all three funds, so they're just paying all of the money managers to flip it to one another.

Munger: In the 1930s, there was a stretch where you could borrow more against the real estate than you could sell it for. I think that's what's going on in today's private-equity world.

Succession

Buffett: When we pass, nothing will change, but there will likely be a hiatus of sorts where people might not have the same feelings about selling their business to Berkshire. The phone might not ring for a while. But that will pass because the people the board has selected to run Berkshire are phenomenal and Berkshire will remain one of a kind.

[Regarding a shareholder's idea of naming a COO today:] I don't think it works well to have a half-and-half arrangement. We don't need an operating guy – we have people running the businesses and the main thing is not to destroy or damage the spirit they have. And as long as I'm around, people will want to talk to me [about selling their businesses].

There will be [negative] stories a year after I die headlined "Berkshire: One Year Later," but that will fade out and my successor will put his own particular stamp on the place. But he won't mess with the culture – he's too smart and it works too well. We're a one-of-a-kind place for certain owners. They have a problem to solve and only we can offer a good home [for their business].

Munger: Speaking for the Munger heirs, I hope they continue to wring the last drop of good out of Warren.

Buffett: At low pay! [Laughter]

If we thought there was some better way to make this place run better or ease the transition, we'd do it, but I don't think there is.

The person [who would take over] knows the business, knows how to make good deals, and knows how to avoid other kinds of deals – which is equally important. Once it [the transition] happened, Berkshire might even be stronger than before because people would realize that it wasn't just about an individual.

Even though Sam Walton died, Wal-Mart has become a stronger company.

Culture and Succession

In our shareholder letter and in this meeting, [we try to make clear what our culture is]. We want managers to join us who believe in what we do and make a lifetime commitment to join us. Once they join us, we want to act consistently and be consistent. They see that it works.

There are plenty of people who don't believe in our culture and they don't join us. It would be bad to have a mismatch. The nice thing about it is that our culture is so well defined that there are rarely mismatches.

We don't have any formal training for our culture – it isn't really necessary.

If I died tonight, there are three replacements. Any of them would not miss a beat in leading this culture.

Munger: If Warren has kept the faith until he's 75 years old, do you really think he'll blow the job of passing that culture along? What could be more important? You all have a lot more things to worry about than the candle at Berkshire going out because some people eventually die.

We don't train executives, we find them. If a mountain stands up like Everest, you don't have to be a genius to figure out that it's a high mountain.

Share Repurchases

Buffett: Most of the time, we wouldn't be able to buy an amount of our stock that would be material to our remaining shareholders. We probably have less opportunity to do so than other large companies.

[Buffett then put up this chart, which showed share turnover last year for the following companies:

Berkshire Hathaway	14.05%
Exxon Mobil	76.32%
General Electric	47.93%
General Motors	487.14%
Wal-Mart	79.33%]

Look at these turnover figures. I think Berkshire has lower turnover by some margin than any major company in the U.S. I put Wal-Mart up there because the Walton family owns more of Wal-Mart than I do of Berkshire, so [our low share turnover is] not just because of that.

Our shareholders are long-term and loyal *owners*. We have the most honest-to-god attitude of ownership of any public company. People buy it to own it. It does mean that if it gets cheap, we won't be able to buy much. But that's OK. We're not looking to make money off shareholders by buying them out at a discount.

The motivation for buying back stock used to be just because companies thought their shares were cheap. Thirty or forty years ago, it was very fertile to invest in companies that were buying back their stock. The most extreme case was Teledyne – we made some money investing there.

But that's being swamped today by companies doing it because it's in fashion or to prop up the stock. The SEC has rules to prevent propping up the stock on a daily basis [but companies still try to do it]. We wouldn't do it for those reasons.

A few years ago, when we were willing to buy back our stock, the fact of writing about it [in the 1999 annual letter, page 16] eliminated the opportunity.

[It's very interesting that Buffett had this slide prepared in advance. I think it's because he knows his stock is cheap – we think it's as cheap as it was on March 10, 2000, the only time he's ever been willing to buy it back – and the company is much stronger and has a much brighter outlook than it did then. Buffett no doubt expected that he might catch some flak from shareholders for not announcing a buyback, but rather than addressing that question directly, he chose to deflect it by basically arguing that even if that would be the best use of Berkshire's capital right now, the stock is too illiquid to buy back much stock anyway.

All of this being said, even if the stock were more liquid, I'm not pounding the table for share repurchases in light of the acquisition of Iscar. I'm drooling at the prospect of more acquisitions like this one – as are, I'm sure, Buffett and Munger.]

Attendance at Annual Meeting and Sales at Nebraska Furniture Mart

The estimated attendance here this weekend is 24,000. Sales at Nebraska Furniture Mart this weekend were $5 million [a few years ago]; in 2003, $17 million; in 2005, $27 million; and we'll do over $30 million this weekend. For perspective, that's a normal *month* of sales. But you all can do more. [Laughter]

COMMENTS ON BERKSHIRE HATHAWAY'S WHOLLY-OWNED COMPANIES AND STOCK HOLDINGS

Insurance Pricing and Risk

In auto insurance, our policies are up more than premium volume, so the average premium is down a little bit. In reinsurance, in which we are a big player, there are great variances. For marine risks on the Gulf Coast (rigs, etc.), prices are up dramatically, as they should be. Premiums paid for this type of risk were $2.5 billion and the payouts were $15 billion [so obviously the pricing wasn't sufficient].

In the past few years, we've been the largest writer of mega-cat insurance in the world, and I'm sure we will be this year. Prices are up a lot, but we don't know if exposures are up even more. We don't know if the experience of the last two years [the worst hurricanes in U.S. history] is to be relied upon more than the past 100 years. They tell you two different things. We do know that it would be silly to assume that the past two years [are outliers]. Atmospheric conditions and water temperatures have changed. This could change the propensity of hurricanes to occur and their severity. If the last two years are relevant [e.g., become the norm], then we're not getting paid enough [for the reinsurance we're writing currently].

The scary possibility is that the changes are continuous and that the changes in the past two years build up. It gets into chaos theory, whereby the output is not a linear relationship. You could dream up some very scary scenarios.

We are willing to write in certain areas and with certain coverages because we can sustain the losses. We're willing to sustain big losses because [we have the financial strength and think we're getting paid enough]. But it's not like flipping a coin or rolling dice – there are many changing variables.

In the third quarter, we will have a lot of exposure to wind [damage claims] – but not as much as a couple of years ago. Prices are hardening in that particular area. If the prices go back to what they were last year, [we will write a lot less].

We don't believe in modeling. The modelers don't know a thing. It's silly. We get paid for making guesses on it. Over a lifetime, we'll know if we were right. Even if there are low losses this year, we won't know if we're right.

It's still a business we like. If there's a super-super catastrophe, say $250 billion (four times Katrina), we would pay maybe $10 billion. We could pay, and comfortably pay, but many others in the industry would be in trouble.

Over 5-10 years, we'll know how well we did.

Munger: The record of the past, if you average it out, has been quite respectable. Why shouldn't we use our capital strength to get into volatile areas that make others uncomfortable?

More on Berkshire's Super Cat Reinsurance Business

Buffett: We're getting close to 10% of the float of the American property and casualty insurance industry, so we can't continue to grow as fast as we have, but it will be attractive. I'm aware of the risks like pandemics – you're aware of them too – and we get offers every day.

We think about $20 billion or $50 billion events and up. It's a question of making judgments of whether we're getting paid enough. We'll know in 30 years. If we have a lot of money then, we'll know we were right. If we take a big loss this year, it doesn't mean we are wrong. What will hurricane losses be in 10 years? I don't know, but I'll keep thinking about it every day.

Munger: The laws of thermodynamics are such that if the water is getting warmer – and I believe it is – the energy of the weather is going to go up.

Buffett: You have this possibility that a 1-2% change can lead to 100%+ increases in losses. That's the game we're playing, but if we don't like the prices we're being offered – and we haven't in many areas – we don't play and we're happy to have someone take our place in line.

Coca-Cola

Coca-Cola is a fabulous company. It will sell over 21 billion cases [of all of its products] around the world and that goes up every year. It's a really wonderful business that sold at a silly price a few years ago. The stock sold at $80 [in the late 1990s] when earnings were $1.50. Earnings are higher quality today [at $2.18 per share in 2005, while the stock trades around $43]. Every year, Coke accounts for a little greater percentage of the liquids consumed in the world.

It has $5-6 billion of tangible assets and makes a similar amount of pre-tax earnings. There are not a lot of big businesses that earn 100% returns on tangible assets.

The stock was ridiculously overvalued, but you can't blame [CEO Neville] Isdell today for that. You can fault me for not selling at 50x earnings.

I expect we'll own it 10 years from now.

NetJets

NetJets has grown rapidly and so far our expenses have grown faster. We have top service, the only worldwide service and the only service with larger planes. I thought we'd have economies of scale, but if anything we've had diseconomies of scale. I could give you reasons, but Rich Santulli knows the business and is addressing it. He works 16 hours a day. There is no one I have greater confidence in to fix this business. High fuel costs are a pass-through but affect the business. I think it'll be profitable before long, but I've been wrong so far.

We have a good business. Nearly everyone who wants a large plane comes to us. We are able to get full price, but expenses got out of control last year. You can hold me accountable for paying a lot of money for the business a number of years ago and we haven't made any money yet.

I looked at Raytheon's annual report and they lost a lot of money in this area, but they're selling their own planes so maybe they don't care.

Munger: The product integrity is so extreme between NetJets [and its competition]. For example, NetJets' pilots are subjected to real oxygen withdrawal so they'll recognize the symptoms. Not everybody does that because it's expensive. They're obsessive about product integrity. My guess is that this will be rewarded eventually.

Clayton Homes and Manufactured Housing

Buffett: [The manufactured-home industry has] an interesting history. There have been years in which manufactured housing accounted for 20% of the new housing stock built in this country, but it's now at the lowest level it's been in 40 years. It's fallen to 6-7% of new housing starts in the past few years, despite considerably better quality – you can look at the two [Clayton Homes] houses on the exhibition floor [of the Qwest Center]. They cost only $45 per square foot. That's good value.

There's been resistance by local builders to manufactured housing, but we've made progress. They're now building subdivisions [for manufactured housing].

[For quite some time until the crash in this industry a few years ago,] the houses were mis-sold. The retailers were selling the houses to people who shouldn't have been buying them, getting the down payment, and then taking the loans and selling them to some insurance company who lost a lot of money. [The subsequent crash] created a hangover that's still being worked through.

[Mortgages on manufactured homes] should be financed on shorter terms. Terms of 30 years are a mistake. The terms got very lax and we're bearing the consequences.

Somewhere down the road there will be 200,000 units [of manufactured housing sold], but not in the next year or two.

The number of competitors is down. Clayton's record is so much better than anyone else's that you have to look hard for the #2 player. Clayton may become biggest homebuilder in the U.S.

Munger: I think [the quality of] manufactured housing will continue to get a lot better and these types of homes will take more of the market. It's so logical that I think it will happen.

Procter & Gamble

It's clear that it's a consumer powerhouse of sorts and Gillette, in its field, has about as strong a consumer franchise as you'll ever see (the blades and razors part of it).

Retailers are becoming more concentrated and brands of their own, so the struggle between manufacturers and retailers will continue. If I were on either side, I'd want to strengthen my hand by getting bigger. I think P&G and Gillette will be stronger as a combined enterprise, given the strength of the Wal-Marts and Costcos of the world.

I don't know a thing about P&G's pharmaceutical business. [A shareholder specifically asked about this.]

Munger: That makes two of us.

How Technological Change Might Affect the Utilities Business

Buffett: We're going to earn a return on capital employed whether we transmit it the old way or whether some new way emerges. We strive to serve our customers and keep their costs down as much as possible.

Even in terms of choosing which generating sources we use, we follow the will of the people in the states we serve. If they want to pick a more expensive way to generate for some reason, that's okay with us. I don't think anything will change our economics. We certainly don't buy a utility expecting to do something else with it.

ADVICE ON INVESTING

Circle of Competence

Buffett: We are best at evaluating businesses where we can come to a judgment that they will look a lot like they do now in five years. The businesses will change, but the fundamentals won't. Iscar will be better – maybe a lot bigger – in five years, but the fundamentals will be the same. [In contrast,] look at how much telecom has changed.

Charlie says we have three boxes: In, Out and Too Hard. You don't have to do everything well. At the Olympics, if you run the 100 meters well, you don't have to do the shot put.

Tom Watson [the founder of IBM] said, "I'm no genius. I'm smart in spots and I stay around those spots." We have a lot of managers who are the same. You don't want to compete with Pete Liegl [the CEO of Forest River, Inc.] because he'll kill you in the RV business. But he doesn't try to tell us how to run the insurance business.

I was virtually there at the birth of Intel. I was on the board of Grinnell College with Bob Noyce [one of the founders of Intel] and Grinnell invested $300,000 into it at inception. [I easily could have as well, but] I had no idea then and still don't now what Intel will look like in five years. Even people in the industry don't. Some businesses are very, very hard to predict.

Munger: A foreign correspondent, after talking to me for a while, once said: "You don't seem smart enough to be so good at what you're doing. Do you have an explanation?" [Laughter]

Buffett: Was he referring to me or you? [Laughter]

Munger: I said, "We know the edge of our competency better than most." That's a very worthwhile thing. It's not a competency if you don't know the edge of it.

Up-and-Coming Role Models to Study?

Buffett: You don't have to study anyone new. Just study people like Tom Murphy and Don Keough [of Capital Cities/ABC and Coca-Cola, respectively]. If you learned the management lessons of Tom Murphy, you don't need to learn any other lessons.

Munger: We're not following the examples of any 40-year-old investors.

Buffett: I didn't know there were any 40-year-old [hedge-fund managers] – I thought they were all 25. [Laughs]

Importance of Conviction in Investing

You didn't have to have a high IQ or a lot of investment smarts to buy junk bonds in 2002, or certain other things after Long-Term Capital Management blew up. You just had to have the courage of your convictions and the willingness to act when everyone else was terrified and paralyzed. The lesson of following logic rather than emotion is obvious, but some people can follow it and some can't.

Munger: When we were young, there weren't very many smart people in the investment world. You should have seen the people in the bank trust departments. Now, there are armies of smart people at private investment funds, etc. If there were a crisis now, there would be a lot more people with a lot of money ready to take advantage.

Buffett: But in 2002, there were all these people with lots of money [and the opportunities were still there].

Munger: When you have a huge convulsion, like a fire in this auditorium right now, you do get a lot of weird behavior. If you can be wise [during such times, you'll profit].

Buffett: Three years ago, you could find a number of companies in [South] Korea with strong balance sheets trading at three times earnings.

Munger: But there was a huge convulsion there.

Buffett: But that was 4-5 years ago. It had already passed.

Munger: You couldn't name 20 more examples like it. [e.g., there are only a few examples in recent times of such weird behavior leading to huge, obvious bargains in entire asset classes.]

Buffett: Even if I could, I wouldn't! [Laughter]

How Buffett Would Manage $1 Million Today

We formed our first partnership 50 years and two days ago, on May 4, 1956, with $105,000. If we were starting again, Charlie would say we shouldn't be doing this, but if we were, we'd be investing in securities around the world. Charlie would say we couldn't find 20, but we don't need 20 – we only need a few that can pay off very big. We'd also be buying [stocks in] smaller companies.

If we were planning to buy [entire] businesses, we'd have a tough time. We'd have no reputation and only $1 million.

Charlie started out in real-estate development because with only a little capital, brain power and energy, you could magnify the returns in real estate unlike in other sectors.

I'd just do it one foot in front of the other over time. But the basic principles wouldn't be different. If I'd been running a little partnership three years ago, I'd have started out 100% in Korea.

Munger: You should find something to invest in and then compare everything else against that. That's your opportunity cost. That's what you learn in freshman economics, even if it hasn't made it into modern portfolio theory. That's why modern portfolio theory is so asinine.

Buffett: It really is.

Munger: When Warren said he'd put 100% of his fund in Korea, maybe he wouldn't quite do that, but pretty much. Most people won't find a lot of great things [to invest in]. Instead, you'll want to find a few things that are much better than anything else. Act on these.

More Keys to Investment Success

Buffett: Ben Graham said you're neither right nor wrong if you're investing with the crowd – you're right if your facts and reasoning are right. Once you have the facts, *you* have to think about what they mean. You don't take a survey.

You should focus on what's important and knowable. There are many things that are important but now knowable, like [whether there will be] a nuclear attack tomorrow. You can't focus on those.

As Ben Graham said in chapter 8 of *The Intelligent Investor*: The market is there to serve you, not instruct you. If it does something silly, it gives you a chance to do something. It just sets prices. If it doesn't give you an opportunity, go play bridge and come back the next day. And the nice thing is that the prices will be different.

During the Long-Term Capital Management crisis, we were getting calls on Sunday from people. By the way, you can make a lot of money on calls on Sunday – that means things are really screwed up. Just make sure you're the callee and not the caller.

At that time, there was [an unprecedented] 30 basis point spread between on- versus off-the-run 30-year Treasuries. All you have to do [in such situations] is make sure you can play out your hand under all circumstances. If you can and you have the right facts – and you let the market serve rather than instruct you – you can't miss.

Munger: I'd say some of you probably can miss. [Laughter]

Student Visits to Berkshire and Investment Education

I will have in this school year close to 40 schools visit. They usually double up, because 20 days is about all I can handle. They offer good ideas and I'm offering two B shares, not the usual one, if I buy a company they recommend – a special one-time offer!

Twenty-five years ago, schools tended not to stray too far from the efficient-markets orthodoxy that not only wouldn't do students any good, but might even get them in trouble. I think it's better today. Prof. Herschey has done a great job at [the University of Kansas]. Missouri, Florida, Columbia [Bruce Greenwald and others], Stanford [Jack McDonald] – a lot of schools – have people in those departments who are doing a great job.

My experience with the students is that they generally have their heads screwed on right.

MBAs Flocking to Hedge Funds and Private-Equity Funds

I enjoy all the students coming out, but they all think they're going to get rich by following in our footsteps. It troubles Charlie even more than I how much brainpower is going into money management.

An awful lot of students say they want to run a hedge fund. It's hard to imagine a world in which everyone's running a hedge fund. I don't know what we'd do for clothing and food.

Munger: I've heard that one-half of the students at elite schools want to go into private equity or hedge funds. They want to keep up with their age cohorts at Goldman. This can't possibly end well in terms of meeting these expectations.

Shorting Stocks and Naked Shorting

Buffett: There's nothing evil about short selling. There are people on the short side who have done things to make some stocks go down – some of which is appropriate and some of which is inappropriate. People do that on the long side as well, so I have no ax to grind with short sellers. We have no problem with anyone shorting Berkshire stock. There's nothing I'd like more than to be paid to lend my stock to shorts.

I do think it's a very tough way to make a living, both financially and psychologically. If you buy something at $20, you can lose $20. If you short at $20, you're loss can be infinite.

As you know, we have a friend who's been outspoken on naked shorting [referring to Overstock CEO Patrick Byrne, who used to be President and CEO of Berkshire subsidiary Fechheimer Brothers]. I don't have a great problem with it. If anyone wants to do that with Berkshire, more power to 'em.

Companies with a large short interest very often have been revealed as frauds or semi-frauds – not the one my friend runs. Over the years, I've probably had 100 ideas of things to short and I would have eventually been right [on almost all of them]. But [because it's so hard to get the timing right,] I likely wouldn't have made much money and there would have been a huge opportunity cost. Someone who's running a fraud is probably very good at it and can keep it going a long time. I would never put money with a short fund – not because I have any problem with it ethically, but because I question if they could make money over time.

Munger: It would be one of the most irritating experiences in the world to do a lot of work to uncover a fraud and then watch it go from X to 3X and watch the crooks happily partying with your money while you're meeting margin calls. Why would you want to go within hailing distance of that? [Laughter]

Thoughts on Jeremy Siegel

[Asked to comment on the theories of author and Wharton Professor Jeremy Siegel, Munger replied:] I think Jeremy Siegel is demented.

Buffett [clearly a little embarrassed]: Well he's a very nice guy.

Munger: He may well be a very nice guy, but he's comparing apples to elephants in trying to make accurate projections about the future.

Commodities

Buffett: I don't think there's a bubble in agricultural commodities like wheat, corn and soybeans. But in metals and oil there's been a terrific [price] move. It's like most trends: At the beginning, it's driven by fundamentals, then speculation takes over. With copper there was a little shortage and then people got worried [and then the price skyrocketed]. As the old saying goes, "What the wise man does in the beginning, fools do in the end." With any asset class that has a big move, first the fundamentals attract speculation, then the speculation becomes dominant.

Once a price history develops and people hear that their neighbor made a lot of money on something, envy sets in and that impulse takes over. We're seeing that in commodities – and housing as well. Orgies tend to be wildest toward the end.

But you never know when it will end. The eyes of the world that never looked at silver at $1.60 are now looking at it. [The price of silver today is around $14/oz.] My guess today is that copper is responding more to speculative pressures than fundamentals.

Munger [dripping with sarcasm]: I think we've demonstrated our expertise in commodities, if you look at our activities in silver. [Laughter]

Buffett: I bought it very early and sold it very early. We made a few dollars. We're not good at figuring out when a speculative game will end.

It's like Cinderella at the ball. At the start of the party, the punch is flowing and everything's going well, but you know that at midnight everything's going to turn back to pumpkins and mice. But you look around and say, 'one more dance,' and so does everyone else. Everyone thinks they'll get out right at midnight.

This is what's happening with copper today, Internet stocks in 1999 and uranium stocks in the 1950s. The party does get to be more fun – and besides, there are no clocks on the wall. And then suddenly the clock strikes 12, and everything turns back to pumpkins and mice.

Silver

We had a lot of silver at one time, but we don't have it now. My original decision was that the production and reclamation of silver were running at 100 million ounces less than the consumption. Now a lot of consumption has gone down, for example in photography, but that's where a lot of reclamation is as well, so it balances out. Silver was out of balance, but there's now a lot above ground and a huge amount could be removed from other uses, which could increase supply, which is what happened when the Hunt brothers tried to corner the market in the early 1980s [actually 1979-80].

There are few pure silver mines – most silver is produced as a byproduct from other mining – so it's not easy to bring on added production. I thought silver would get tight. I was early and sold early.

[To the questioner:] You're right that a commodity doesn't earn anything, so unlike a company, in which earnings are accumulating every year, you have to sit with a commodity and hope for a shift in the supply and demand. It's a big drawback.

Munger: We didn't get where we are by owning non-interest-bearing commodities. It's a good habit to trumpet your failures and be quiet about your successes.

Buffett: Well, we have a lot of to trumpet then! [Laughter]

Challenges to Newspapers and Other Media

People will always want to be entertained and informed, but the choices for doing so were far fewer 50 or 60 years ago. As the years have gone by, technology has produced a variety of new ways to be informed or entertained, but we still only have two eyeballs and 24 hours per day. And any time there's more competition, generally that's bad for business.

Newspapers are still highly profitable, especially compared to tangible capital employed, but the outlook isn't nearly as rosy as it was 20-30 years ago. The audience is going down and that *has* to erode the economics over time. People also like to talk about how more competition [is good for business, but it's not true].

At one time, [the major television networks] had a license from the government and were the only three highways to the eyeballs of hundreds of millions of people for advertisers like GM, Ford and Gillette to choose from. But now there are many highways. It's hard to imagine these businesses [the networks] getting better in aggregate over time.

The key would have been to buy the NFL [National Football League; e.g., content] at inception.

We still own World Book [encyclopedias]. At one time, we sold 300,000 sets for $600 each. The problem is [that with the advent of the Internet] you could get a good bit of the same information without cutting down tress, delivering the books, etc. The problem wasn't that the product wasn't worth the money, it's that people have other alternatives. I don't see anything that will change this.

Munger: It's simplicity itself that its future will be way worse than its past.

Investing in Newspapers

Buffett: What multiple would you pay for a business earning $100 million, which is going down 5% per year, versus the same business with earnings growing 5% per year? I'm not saying those are the numbers I'd use for newspapers, by the way. I do not think newspaper circulation, or ad pages, will be larger in five years – even in areas of the country that are growing [in population].

Newspaper multiples are uncomfortably high if you believe profits are going to decline. Prices today do not reflect earnings declining at 5-6% per year. There's also the risk that [owners of newspaper businesses] don't fully recognize the situation and will buy other newspapers at too high a price.

This comes from someone who loves newspapers and couldn't do without them. I read five newspapers every day. Charlie does too. But people can [do without them]. The decline, if anything, has accelerated somewhat. When they take people to the cemetery, they're losing readers, but when they graduate from college, they're not gaining any readers. The virtuous cycle isn't true anymore, but prices don't reflect this.

We love them as products and thought they were the greatest of companies with bulletproof franchises. We were wrong.

Munger: I have a greater sin to confess to. I once thought GM was a bulletproof franchise.

But we have a method of coping: we just put it in the "too hard" basket. If something is too hard, we move on to something that's not too hard. What could be more simple?

Buffett: It used to be the easiest business model to understand.

In the 1991 annual report, I wrote about [advertising] preprints, and how there was nothing magical about the newspaper, but that it brought the preprints inside the house. [I'm not sure what Buffett was talking about here – the word "preprint" doesn't appear in the 1989-1992 annual reports, but his discussion in his 1991 letter of the declining economics of the media business is fascinating and his conclusion was amazingly prescient: "Most media properties continue to have far better economic characteristics than those possessed by the average American business. But gone are the days of bullet-proof franchises and cornucopian economics."]

It has been interesting for me to watch both direct owners and investors in the newspaper business resist seeing what's right in front of them. It [newspapers' superior economics] went so long the other way. You couldn't make a mistake buying a monopoly newspaper business [meaning a town in which there was only one newspaper] until 1975 or 1980.

Munger: If the technology hadn't changed, they'd still be great businesses. Network TV [in its heyday,] anyone could run and do well. If Tom Murphy was running it, you'd do very well, but even your idiot nephew could do well.

Fortunately, carbide cutting tools [such as those made by Iscar] don't have these types of substitutes.

Investing Based on Big Trends

Buffett: We don't play big trends like demographic trends. They just don't mean that much. There's too much money to be made year to year than worry about trends that take ten years to play out. I can't think of one investment we've ever made based on a macro or demographic trend.

Munger: Not only that, but we've missed the biggest commodity boom in history – and we'll continue to miss things like this!

Buffett: But we'll search for new ways to fail! [Laughter]

Investing in Brazil and Other Developing Countries

Our problem with many markets is that we have to put out a lot of money because we're so big. We have to invest hundreds of millions of dollars, which really narrows the companies and countries we can look at. In the case of PetroChina, the biggest company in the world's most populous country, we were only able to invest $400 million.

In Brazil, there's a great beer company a friend ran and we should have invested in it. He's a great manager. Brazil wouldn't be off limits, but we would have to be able to invest a lot of money in a good business we can understand at a good price. And it would have to be cheaper than a comparable U.S. company, to compensate for the extra risk and our relative lack of knowledge about the market.

Investing in Russia

In 1998, via our ownership in Salomon Brothers, we were in the oil business and drilled for oil in Siberia. They were happy to have us drill, but when it came time to take the oil out, it was harder. Given that experience, [we won't be rushing back to invest in Russia].

About three years ago, I had breakfast in Sun Valley with Mikhail Khodorkovsky [the former CEO of Yukos], who was considering a listing on the New York Stock Exchange. He's now in jail and Yukos is in bankruptcy with tax claims. It's a little hard to develop a lot of confidence that [Russia] has changed vis-à-vis its views toward capital, especially outside investors and capital.

Munger: [This reminds me of a story that ends:] "If they ever do find any oil, that old man will steal it." I'm afraid we have the same problem today in many countries with oil.

Buffett: Charlie, didn't we have the livelihood of our guys threatened [in Russia]? We sent guys to get the [oil-drilling] equipment and they were told that not only would they not get the equipment, but if they tried, the guys wouldn't get out either. It wasn't that long ago…

Investing in Ethanol

Charlie and I do not know enough about the [ethanol production] business to evaluate it. We've been approached many times and they're quite popular, but trying to figure out the economics of an ethanol plant will depend on government policy and a lot of other variables we're not good at predicting. It's also a very hot area for investors right now, and our general experience is that we don't participate in things that are hot and easy to raise money for.

I have a brother who's on the ethanol board of Nebraska and [if he becomes richer than me, I'll reconsider my views on ethanol]! [Laughter]

There's no question that ethanol usage will grow. But generally speaking, agricultural processing – companies like Cargill and ADM [Archer Daniels Midland] – have not been great businesses and have not earned high returns on tangible capital. Ethanol could prove to be an exception, but I'm not sure how you gain a significant competitive advantage with any particular ethanol plant.

Munger: My attitude is even more hostile than Warren's. I know just enough about thermodynamics to understand that if it takes too much fossil-fuel energy to create ethanol, that's a very stupid way to solve an energy problem. [Laughter]

Investing in Healthcare

A lot of people have made a lot of money selling health insurance. I've seen it as Chairman of a central-city hospital [the Good Samaritan Hospital in Los Angeles]. You're right that there have been a lot of bad ethics. A lot of good ethics, too.

Generally, [investing in the healthcare area] goes into the "too hard" pile – unless Warren's been keeping something from me.

Buffett: No, we've never done anything in healthcare.

Munger: You [the shareholder who asked the question] are right though – the worst of the ethics is really bad.

Closed-End Funds

Buffett: History shows that over time, almost all closed-end funds go to discounts. Initially, if they're sold with a 6% commission, the initial people only get 94 cents on the dollar. If I could buy an open fund at X or a closed-end fund at 120% of X, then you'd have to convince me that the management is something special to buy the closed-end fund.

Occasionally, Charlie and I have seen closed-end funds that trade at a premium for a long time. Eventually they will come back down to earth.

COMMENTS ON FINANCIAL COMPANIES AND RISKS IN THE FINANCIAL SYSTEM

Views on the Dollar

My views [on the likelihood of the dollar weakening] are as strong as ever, perhaps a bit stronger. It's almost certain that the U.S. currency will weaken over time as a result of the fiscal and monetary policies we're currently following. I don't know about the next six months, but certainly over time.

We are doing less directly in currency futures because the carry costs have gone from positive to negative. In my view, there are considerably better ways to protect against the dollar getting weaker in the future. For example, we like to invest in companies, like Iscar, whose earnings are primarily in other currencies. We earn a lot of money in other currencies.

[Buffett read a quote about the dangers of running a large current-account deficit that ended, “Countries that have gone down this path inevitably run into trouble.”] Guess who said that? Alan Greenspan. When he said that in 2002, the current account deficit was $385 billion. Now it’s double that. In his later years as Fed chairman, he didn’t emphasize this view as much, but he didn’t repudiate it either.

It’s going to lead to trouble. People talk about a soft landing, but they don’t ever say how. [Current Fed Chairman Ben] Bernanke said he expects a soft landing, but also said there’s the possibility of something worse.

One possible outcome is significantly higher inflation. As you owe more and more, it’s tempting to devalue the currency in which the debts were incurred.

Munger: Generally speaking, it can’t be good to be running a big current-account deficit and a big fiscal deficit and to have both growing. A great civilization may be able to stand something like that for a longer period than you’d imagine at the outset, but you’d think at the end there’d be a comeuppance and you’d have to adjust and it would be painful. Do you agree Warren?

Buffett: Yes. I don’t see how people say it’s sustainable.

The longer it goes on, the greater the net debt position builds up and the more people see it. And then something perhaps extraneous causes some big adjustments to take place and the result is chaos, in which currency adjustments play a part. But it’s impossible to predict this.

Years ago, portfolio insurance was popular. People were selling this as a sophisticated way to manage money and mitigate risk – and they earned a lot selling it. Then October 19, 1987 came along. A relatively small portion of American investments were being guided by this doctrine, but just this small amount of money was the leading factor in a 22% one-day drop [in the Dow]. Everyone thought they were being reasonable, but they created a doomsday machine.

I think the odds of something like this – though not this exactly – is magnified today compared to the 1980s. I don’t know who will yell fire, but when it happens, I’m sure the currency markets will play a role in the race for the door.

More on the U.S. Current Account Deficit

We have earned more on American assets owned by people outside this country than the reverse. The net balance flipped in the most recent quarter and I expect this to continue. One reason is that the foreigners owning our Treasury bonds were getting only a little over 1% not long ago, so this was leading to a favorable balance. Now, that’s turning as our interest rates are up. And, over time, it’s going against us.

Now if you consider the magnitude and consequences of our $3 trillion net debtor position, that depends on what the dollar does. Over the past few weeks, the dollar has weakened, which reduces our debt, but could lead to inflation. Overall, [these trends] will not be favorable.

Munger: This is not a field to which I've devoted the same attention as Warren, but I do share his general pessimism that there will be a price to pay for the course we're on. I've always thought we could get away with more ruinous behavior than Warren has. We started from such a strong position. It's not as if the alternatives are all so great. I can understand why people would rather invest in the U.S.

Buffett: Yeah, if you landed from Mars, you'd still rather land in the U.S. than anywhere else.

Munger: Do you want to be in Europe, where 12-13% of people are unemployed and most 28-year-olds are living at home and being paid by state to do it? Or be in Brazil or Venezuela with the political instability that you fear? It's not totally irrational that people still like the U.S., despite its faults. Whatever misbehavior there is could go on quite a long time without a price being paid.

Buffett: I agree. This is the country that could sustain fiscally irresponsible policies for a long time. We still think this is the best place to be. But I also think there's a chance for something to suddenly go wrong.

How Salomon Almost Triggered a Global Financial Crisis

It's hard to tell what will cause a crisis: who will yell fire, how many people will rush to the exits, etc.

Look at Long-Term Capital Management, or what happened to the junk-bond market in 2002. It almost closed. It was chaos.

In mid-August 1991, when we were at Salomon, on a Sunday we were within half an hour of seeking out a Federal judge and handing over the keys and filing for bankruptcy. The lawyers were drafting the bankruptcy documents. Fortunately, [the Treasury ruling that would have forced Salomon to seek bankruptcy protection] was reversed.

But what would have happened if we'd filed? Coincidentally, Gorbachev was spirited away the same day [Monday, August 19] and the Dow was down a few hundred points. What would have happened when the markets opened in Japan if Salomon Japan couldn't deliver securities, etc.? Plus, Salomon had a $600-700 billion derivative book.

Munger: It could have been absolute chaos.

There's a very interesting story, with an interesting moral. Nick Brady was Treasury Secretary at the time. He was a Berkshire shareholder because of his long relationship with the Chaces.

[From Buffett's 1991 annual letter: "Malcolm G. Chace, Jr., now 88, has decided not to stand for election as a director this year. But the association of the Chace family with Berkshire will not end: Malcolm III (Kim), Malcolm's son, will be nominated to replace him. In 1931, Malcolm went to work for Berkshire Fine Spinning Associates, which merged with Hathaway Manufacturing Co. in 1955 to form our present company. Two years later, Malcolm became Berkshire Hathaway's Chairman, a position he held as well in early 1965 when he made it possible for Buffett Partnership, Ltd. to buy a key block of Berkshire stock owned by some of his relatives. This purchase gave our partnership effective control of the company. Malcolm's immediate family meanwhile kept its Berkshire stock and for the last 27 years has had the second-largest holding in the company, trailing only the Buffett family. Malcolm has been a joy to work with and we are delighted that the long-running relationship between the Chace family and Berkshire is continuing to a new generation."]

Munger: He [Nicholas Brady] knew about us and was following the story. He trusted you, Warren, and I think that mattered.

It was terrifying what could have happened that day.

Buffett: Kim Chace, who I introduced you to earlier [at the beginning of the meeting, Buffett introduced all of Berkshire's directors], his father introduced me to Nick Brady when I was in my 30s. [In 1991,] he was head of the Treasury and they had issued a death sentence to us [Salomon] that morning. Fortunately Nick reversed it. [Had he not, we would have filed for bankruptcy and] it would have been a case study for a daisy-chain type of panic.

That was nothing compared to what would happen now. It's not an experiment that you would want to voluntarily conduct, let's put it that way. [Nervous laughter]

Housing Financing and Poor Accounting

Munger: Some of the worst sins in manufactured-housing financing have gone over to the financing of stick-built homes. A lot of ridiculous credit is being extended in the U.S. housing sector. There was a horrible aftermath in manufactured housing and my guess is that we're likely to see something similar [as a result of the unwise credit being extended in the overall housing sector].

Buffett: Look at the latest 10-Qs of financial institutions and the levels of accrued, but not paid, interest. You'll see some interesting things. It's growing rapidly, which means the lenders are booking earnings, but not receiving the cash [e.g., borrowers are falling behind in their payments].

Dumb lending always has its consequences. You can have an epidemic and not realize it until you're very far into it. You had it in commercial real estate in the 1980s and the RTC [Resolution Trust Corporation] was the result. A developer will build anything he can get financing for.

Munger: Some of the dumb lending is facilitated by contemptible accounting. The accounting profession [has continued to disgrace itself here].

Likely Housing Bubble in Certain Areas

Buffett: We developed a piece of property for 20 years in California.

Munger: I think we got our money out, plus interest [e.g., a terrible rate of return, given the time and effort].

Buffett: It's not an exaggeration. The land value was $5-6 million when we sold. We finished at the wrong time. What do you think it would be worth now, Charlie?

Munger: $100 million.

Buffett: The swing in property values has been huge in some markets. What we see in our residential brokerage business [HomeServices of America, the nation's second-largest realtor] is a slowdown everywhere, most dramatically in the formerly hottest markets. The high end and where properties were bought for investment and speculation are doing the worst.

If you buy a house for $300,000 and take a $270,000 mortgage, you're going to stay there and continue to make your mortgage payments, even if the market value of the house falls (unless something bad happens to you like losing your job). But if you have investors and speculators holding the properties – effectively day traders in the condo market – that kind a speculation can produce a market that can move in a big way. First the buying and selling stops and then the market reopens. With stocks, they will trade every day, so you can't kid yourself. If you own GM stock and it's down on Monday, you know you've taken a loss. But in housing, there's always the hope that you can find the one seller who will pay the price you want, who hasn't heard that the market has collapsed.

In [Miami-]Dade and Broward counties in Florida, the average condo costs $500,000. [I may have the numbers slightly off here:] Not long ago, there were 3,000 condos listed and 2,900 sold every month. Today, there are 30,000 condos listed – worth $15 billion – and only 2,000 per month are selling. The whole supply-demand equation has changed.

We've had a real bubble to some degree. I would be surprised if there aren't some significant downward adjustments, especially in the higher end of the housing market.

Munger: There's a bubble among high-end apartments in Manhattan, but in Omaha, housing prices are reasonable.

Is Inflation Being Measured Correctly?

Buffett: [PIMCO's] Bill Gross has written about whether inflation is being captured correctly. If you go out to the Nebraska Furniture Mart, you'll see that prices haven't moved up much over time. And in some areas, like DVD players, prices are down 75%, so there's been deflation.

But when I see that "core" inflation excludes food and energy, I can't think of anything more core than food and energy. Also, the CPI [consumer price index, the official measure of inflation] uses a computed rental price, but this does not reflect new housing prices. The rental factor has significantly lagged the rise in housing.

But if you own your own house and drink Coke, you're less affected – my CPI, for example, hasn't changed very much. But if you're buying a house and drive 40 miles to work every day, your CPI has gone up a lot.

Munger: I see almost no change in the price of the composite product that flows through Costco [Munger is a Director of Costco]. I don't feel sorry for the people who pay $27 million for an 8,000-square-foot condo in Manhattan. So inflation comes in places.

Buffett: Costco's and Wal-Mart's LIFO adjustments are almost nothing – it's inconsequential. [LIFO stands for "last-in, first-out", and means that when a product is sold from inventory, its cost is based on the price paid for the latest such items purchased by the company. If the cost of the product is rising rapidly, this can cause the old inventory to become valued at less than the current market cost, necessitating a LIFO adjustment. In contrast, if there's no inflation, the LIFO adjustment is nil.] You're dealing with $200 some billion in sales at Wal-Mart and the LIFO adjustment would pick up any inflation [but it's not there].

In our jewelry stores, there have been big LIFO adjustments recently. It's the same with our steel operations. Carpet prices went nowhere for 20 years, but because it's petroleum based, it's moved up a lot recently and now we have $100 million or so in LIFO adjustments.

Overall, for a typical young family, the CPI probably understates inflation in terms of their living situation.

COMMENTS ON GENERAL BUSINESS AND ECONOMIC MATTERS

Majority Voting and Corporate Governance

Munger: I don't think it'll have any effect at all on the ethics in corporate boardrooms. There are fads and fashions. I don't think the troubles will be fixed by something like that.

Buffett: In the boardroom, it's partly a business situation and partly a social situation. The key is: Do they think like owners and, even if they do, do they understand enough about business that their decisions are any good? We've been on many boards and I've never seen any difference in behavior based on the nature of the votes that got them there. But I think you'd be blown away by the difference in savviness and whether people think like owners.

There are all these fashions on corporate governance, but the key job of the board is to hire the right CEO, keep him from overreaching, and exercise independent judgment on important acquisitions. Even smart CEOs are motivated by other than rational reasons when it comes to acquisitions. Directors have not done well in these three areas over time.

The only cure to better corporate governance is if very large shareholders zero in on these things. If they focus on other issues, they'll have fun and get in the papers, but won't make a difference. But if the largest shareholders say, "This compensation plan doesn't make any sense" and withhold their votes for directors, *that* will make a difference.

I just found out that some big institutions are even farming out their voting to someone else. I was amazed. They don't want to think like owners and we all pay the penalty for that.

To effect change, large shareholders – not a coalition of small ones – need to act.

Activist Investors

Activists are using new powers. That crowd is a mixed crowd [in terms of quality], to put it gently.

Critique of "Helpers"

Munger: There are certainly a lot more helpers. The ones who come here [to the Berkshire annual meeting] are the best of them, so don't judge the class by the ones here.

The best thing you can do as you think about following in Warren's footsteps is to reduce your expectations.

Buffett: If your wife is going to have a baby, you'd be better to call an obstetrician than do it yourself. If your pipes leak, you should call a plumber. Most professions add value beyond what the average person can do for themselves. But in aggregate, the investment profession does not do this – despite $140 billion in total annual compensation. It's hard to think of another business like that. Can you, Charlie?

Munger: I can't think of any.

Buffett: It's become a bigger and bigger business. And the more you charge, the more money you bring in. It's useful to get into a business like that. When I speak to students, I ask them to name a great business. One answer is running a business school, because the amount you charge is a sign of prestige. No one wants to go to the business school that charges $20,000 in tuition, but if the school charges $40,000, more do.

In the investment field, you now have large portions of investment managers that charge fees that, in aggregate, cannot work out for investors. Obviously, some [investments in high-fee managers] do [work out well]. But you can't pay 2 and 20 [2% annual management fee and 20% of the profits, standard for private-equity and hedge funds], in which you pay the manager 20% of the profits if they make money and, if they don't, they just close up and reopen later. If you charge this in an economy that's only growing a few percent a year, the math doesn't work. The question for you is how to pick out the exceptions [e.g., the managers who will outperform, even after fees]. Everyone who calls on you says they are the exceptions.

I will bet you that if you name any 10 partnerships with over $500 million in assets and put them up against the S&P 500, they will trail the S&P, after fees, over time.

If you know enough about the person and how they've done in the past, you can occasionally find someone. But if you're running a big pension fund, with everyone calling on you, you will likely invest in the best salespeople.

Munger: I think it ought to be a crime [for an investment manager or his agent] to entertain a state pension-fund manager, and it should be a crime for that person to accept it.

The whole concept of the house advantage is an interesting one in modern money management. The terms of the managers of the private partnerships look a lot like the take of the croupier at Monte Carlo, only greater.

Buffett: Is there anyone we've forgotten to offend? [Laughter]

Management Compensation in a Cyclical Industry?

Buffett: That's a terrific question. If you run a copper company and it's at $3.50/lb., you could be the village idiot and coin money. But if it's at 80-90 cents/lb., which is what it's been for most of my life, there can be tough times.

We have a wide range of businesses at Berkshire – some are easy to run and some not. We have a wide range of compensation systems. Most people, left to select their own compensation systems, [will pick one that gives them big guaranteed rewards].

If we owned a copper-mining company in its entirely, we'd base compensation on costs of production, which management has control over, rather than things based on market prices, which they don't control. Costs won't fluctuate a lot. Compensation should tie to what is under the control of management. Try to understand what management can have impact on.

At GEICO, we measure and compensate management and employees on two factors: unit growth and the profitability of *seasoned* business. (New business initially costs us money and we want it, so we don't penalize for it.)

If oil is $70 per barrel, I don't think management has anything to do with it – in fact, they denied they did in front of Congress. I'd measure the cost of finding new reserves over time – the ability to discover and extract oil at low unit costs. Some firms are much better at this than others.

Management Compensation in General

Munger: It's easy to have a fair compensation system like we have at Berkshire. A lot of other public companies have fair systems, but about half have grossly unfair systems in which top management gets paid too much. But our impact on this matter has so far been about zero.

Buffett: We have 68 operating companies and I have responsibility for compensation of 40 managers (some have businesses grouped under them). I can't think of anyone we've lost over a 40-year period because of different views on compensation. We've never had a comp consultant (maybe at a subsidiary, but they're smart enough not to tell me [Laughter]). It's not rocket science. But a complicated, confusing system works to the advantage of people who have their hand on the switch.

I was put on one comp committee, and Charlie can tell you what happened…

Munger: We were the largest shareholder at Salomon, we were both on the board and Warren was on the comp committee. [When it came time for bonuses, there was] a frenzy of envy. Warren pushed toward slightly – and I emphasize slightly – more reasonable compensation and was voted down.

Buffett: Charlie used term the term envy, not greed. Our experience is that envy is what really drives people. You can give someone a $2 million bonus and they're happy until they see the next guy got $2.1 million and then they're miserable.

Charlie has pointed out that of the seven deadly sins, envy is the most useless, because you just make yourself msierable and can't sleep. There's real upside to gluttony – I've had some great times with gluttony. And we won't get into lust. [Laughter]

Incidentally, the SEC wants more transparency in pay, which is a good idea, but it can become a shopping list. One CEO sees the other getting his haircuts paid for and he wants it too…

Reform of Bankruptcy Process

We bought Fruit of the Loom out of bankruptcy and have invested in junk bonds [of bankrupt companies]. We got involved with Fruit of the Loom first by buying the bonds.

Munger: I think much of [how bankruptcy is handled] is pretty horrible. It's a situation where courts themselves have gone into the business of bidding to attract bankruptcy proceedings. They've found that if they develop a process in which they over-pay people (lawyers, etc.), they can attract the most cases. It's so upsetting to watch that I don't follow it as much as I should. I'm an old man and I don't like to have an upset stomach. [Laughter]

Buffett: We bought a lot of the Enron bonds called Ospreys. The Ospreys were a complex situation and we considerably more than tripled our money. In other situations, we got outbid, like with Burlington and Sitel. We owed all of the Sitel bonds, though, so we came out fine.

Anytime there's something big and complicated, there might be some mispricing. But recently, [the mispricing has] been on the high side. Many people are looking [in this area], so it's a field that does not have a lot of potential right now, but it will again.

Over the next 10-15 years, we're likely to do something big in the bankruptcy area.

Munger: I remember the Eastern Airlines bankruptcy. The courts abused the senior bondholders to protect the employees and communities. Based on the law, you'd have come to one conclusion and the courts did the opposite.

There are a very interesting set of dynamics [involved in these types of cases].

Buffett: With Penn Central, a judge said it was too complex and came up with a quick, fast solution. It worked out well, but it wasn't what the book said should be done. Judges can do what they want.

I remember a case in Cincinnati we talked about earlier [I'm not sure what he was referring to] and when we were on our way up there, I asked Charlie, "How much power does a judge have?"

Munger: And I answered, "As much as he thinks he has."

Income Distribution and Tax Cuts for the Wealthy

Buffett: Corporate profits today are close to their highs, except for a few years after World War II. Incidentally, corporate taxes are nowhere near their highs, so there's a disconnect there.

It is certainly true that in the last 5 to 10 years, the disparity in income has widened significantly and the tax breaks for the wealthy have been extraordinary. I've said in the past that most of the members of the *Forbes* 400, myself included, pay a lower percentage of their income in taxes than their receptionist. This wasn't true decades ago and it's wrong in a rich society.

In 2004, my tax rate was the lowest of the 15 people in my office – and I'm not taking advantage of any tax shelters – and it's even lower in 2005. That's crazy. I don't think the American people understand that, and if they did, they wouldn't be very happy about it. I don't think the average American has participated in the growing wealth of the country over the past 10 years.

Munger: GDP per capita figures have been very good. I wouldn't get too wild about the median income. There are huge fluctuations up and down. What's really important is that the pie keeps growing.

That being said, I don't disagree that Warren's right about too many tax cuts for the wealthy, but I don't think it's as important.

ADVICE ON LIFE AND OTHER

Philanthropy

Buffett: You have to pick the things that are important to you. For many people, it's their church or their school or schools generally. To some extent, you should give to whatever gives you the most satisfaction.

I like to think of things that are important but don't have natural funding constituencies, but for most people there's nothing wrong with giving to things that give them satisfaction. You don't have to be as objective about that as you are when picking securities. I'd go where my gut told me.

With large sums, I'd think about how the money could impact a big societal problem that doesn't get enough attention.

Danger of a Nuclear Attack in the U.S.

Buffett: I couldn't agree more that the ultimate problem of mankind is a state-sponsored use of a nuclear weapon. It will happen someday.

Thousands of years ago, if you wished evil upon your neighbor, you threw a rock, but since 1945, the potential for inflicting enormous harm on a large number of people has increased geometrically.

To those who believe the idea that if we solve poverty it will take care of the problem, I'd remind you that the only country to use nuclear weapons on another is us.

What holds the danger in check is a lack of knowledge, materials and deliverability. But knowledge is getting more widespread, and materials are too.

I don't know how money attacks this, but I think this should be a top priority, at least for my foundation.

There are six billion people and a few percent are really crazy and they would like to do great harm to a lot of people. And only one has to succeed. I don't know how many we've stopped. It could be state-sponsored or by a terrorist.

As for how our company and stock would do, Berkshire is better positioned than anyone else, but that won't make much difference.

Munger: I think chances that we won't have any nuclear attacks over the next 50-60 years is probably zero. But I don't think there's anything we can do about it.

Buffett: You can elect leaders who are very aware of the problem and devote efforts to mitigate it. The genie's out of the bottle, but you'd like to have leaders who focus on this. Both candidates in the 2004 Presidential race agreed that it was the biggest problem we faced.

Comments on Social Security and How to Allocate Entitlement Spending

Buffett: Every society has to decide how to allocate wealth. Starting in 1935, we formally took the idea that the government should provide for the elderly. The government has always been there for young, via schools. Perhaps the idea that 65 isn't the right age for retirement anymore is correct and more change is needed.

This country has output of nearly $40,000 of GDP per capita. Some people like Charlie and me are wired to earn a lot in our society, but many people aren't [and they need to be taken care of in their retirement]. Our country can easily handle the Social Security issue. It astounds me that a government running a $300-400 billion deficit now is worried about a $100 billion deficit decades from now. We produce more every year as we go along. There's always a debate over how to split the pie, but it's a huge and growing pie so we can take care of older people.

Munger: Of course if we don't change anything, Social Security will run low on funds. But if we grow, then it's child's play to [deal with this problem]. And it's crazy to think we'd freeze the amount we'd pay to the elderly. Social Security is a low-overhead, efficient program. I wish my own party would wise up on this issue.

Buffett: This is what happens when you ask a couple of old guys about how much to give to the elderly. [Laughter]

Politicians are very happy to talk about the Social Security surplus and trumpet that, but when there's a deficit decades out, they panic. There's a lot of hypocrisy.

Illegal Immigration

Buffett: I think illegal immigration is a problem and should be addressed quickly. I don't think 11 million people should be shipped home. I also think more liberal rules going forward should be enforced.

I don't think it would have a dramatic effect on the economy if the people here illegally became legal. [I missed this, but I think he said something like costs at businesses that employ illegal immigrants would go up and would be passed along, but the impact would be minor.]

Who's to say if Charlie and I were born elsewhere that we wouldn't try to get in, so I'm sympathetic [to the illegal immigrants].

Munger: If you don't like the results, get used to it. We have never had the will to enforce the immigration laws. What you see is what you'll continue to get.