

Whitney Tilson's 2007 Berkshire Hathaway Annual Meeting Notes

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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

There were 27,000 people at the meeting, which started, as always, with the movie. There was an opening cartoon with Buffett, Munger and Gates, excerpts from past movies (Buffett testifying in front of Congress in the [Salomon scandal](#), etc.), the usual new GEICO, Coke and Dairy Queen commercials, and a new segment in which Buffett and LeBron James play a one-on-one basketball game (Buffett won, of course, with an over-the-shoulder half-court hook shot).

Then Jimmy Buffett sang "Margaritaville" with new words. The refrain was: "Wastin' away again in Berkshire Hathaway-ville, searchin' for some good companies to buy."

Then Buffett and Munger took the stage, equipped with their typical supplies of Coke and See's Candies. Buffett quipped, "Charlie can hear quite well and I can see, so we work well together."

Buffett did a beautiful tribute to Lorimer Davidson ("Davy"), who joined GEICO in 1948, was Chairman and/or CEO from 1958 to 1970, stayed on the board until 1978 and died in 1999 at the age of 97. He helped teach Buffett about the insurance business and was a close personal friend. Buffett showed a video of Davidson, a year before he died, telling the famous story of when he first met Buffett. [Buffett recounts this story in his 1995 annual letter – see the excerpt at the end of this document. To read an article Buffett published later that year recommending GEICO, called "The Security I Like Best," click [here](#).]

Buffett was a business school student at Columbia, a student of Ben Graham's, who was then the chairman of GEICO. Buffett took the train down to Washington D.C. one Saturday and found the doors to GEICO's headquarters locked, but a janitor let him in, Davidson happened to be there and they ended up

talking for four hours. In the video, Davidson said he immediately knew Buffett was something special – he knew all about GEICO and asked exactly the right questions.

After the five-minute video ended, Buffett spoke with some emotion about what a great friend and great man Davidson was.

(I think the hardest part about getting older for Buffett is not his own advancing age – he looks great physically and his mind has never been sharper – but losing so many of the people closest to him: his wife Susie, Kay Graham, Davidson, etc.)

Berkshire's Q1 Results

[To read the Q1 earnings release and 10Q, click [here](#) and [here](#).]

It was a good first quarter. The insurance earnings are going to go down, there's no question about that. How much will depend on mother nature and a few other factors. It's been an extraordinary period, in which there have been no major disasters. This favorable outcome has caused [insurance] prices to go down. There's a lag effect, however, because we realize the premiums and profits from policies written last year [when pricing was much stronger] over time. As this year progresses, our insurance results will show the effect of lower prices.

We had the most benign hurricane season imaginable last year. When hurricanes occur, we'll pay out a lot of money. We hope over time to more or less break even on our underwriting. When you see last year's profit, look at it as an offset to future losses.

You'll notice in our earnings report that accounts receivable went up by \$7 billion, which was due to the Equitas transaction, which closed at the end of the quarter. A couple of days later, we received cash and securities, which we sold, so the \$7 billion went from accounts receivable to cash early in April. [[Here](#) is Berkshire's press release regarding the deal and [here](#) is a blog post analyzing it.]

Most of our non-insurance businesses did fine. Our residential construction-related businesses like Shaw, Johns Manville and Acme Brick were hit, and in some cases hit hard. My guess is that that continues for quite a while. But compared to other companies in the sector, our managers continue to do an absolutely sensational job. We have the best managers – and shareholders – of any company.

Iscar

[Buffett talked about the trip he and Munger made to Israel to visit Iscar and they showed some photos of their visit to Iscar's major plant, which is located only 10 miles or so from the Lebanese border. They were incredibly impressed. Munger commented: "It was a great experience. I have never seen anything as automated as that Iscar operation. I think they view it as a disgrace if any human hand has to do anything."]

Shareholder Resolution for Berkshire to Divest its PetroChina Position

[Buffett mentioned the shareholder resolution calling for Berkshire to divest its stake in PetroChina due to the genocide in Darfur. Buffett said this would be discussed in detail during the formal meeting, which took place in the afternoon after the Q&A session. He noted that only 1.8% of shareholders voted in favor of the resolution, both among A and B shareholders, and said, “Even if you leave out my personal vote, it’s about a 25-1 margin that voted in opposition.”

The meeting then turned to the Q&A, which went from 9:30 am to noon and then from 1-3 pm.]

COMMENTS ON BERKSHIRE HATHAWAY

What explains the extraordinary success of Berkshire Hathaway?

Munger: You won’t have anything like the past to look forward to. Berkshire’s results have been so extreme that it’s hard to think of a precedent in the history of the world. The balance sheet is gross considering the small beginnings of the place.

What has caused this extreme record to go on for such a long time? I would argue that it started with a young man reading everything when he was 10 years old, becoming a learning machine. He started this long run *early*. Had he not been learning all this time, our record would be a mere shadow of what it is. And he’s actually *improved* since he passed the age at which most other people retire. Most people don’t even try this – it takes practice.

So it’s been a long run, with extraordinarily concentrated power by a man who is a ferocious learner. Our system ought to be more copied than it is. The system of passing power from one old codger to another is not necessarily the right system at all.

Berkshire has a very strong culture that will continue after we are gone. We have the talent here to do a lot of wonderful things over time, but they won’t be brilliant things – except once in a blue moon – because we have too much money. The key is to avoid making mistakes. We have the right vehicle with the right standards. This is a *very* rational place.

Berkshire’s Next Chief Investment Officer

Buffett: I mentioned in the annual report that in looking for an investment manager to succeed me, we’re looking for someone who doesn’t only learn from things that have happened, but can also envision things that have never happened. This is our job in insurance *and* investments. Many people are very smart, but are not wired to think about things that haven’t happened before.

[In response to another question on the same topic:] We’re looking for one or more people – it’s entirely possible that it could be three or four people. We’re

not looking for someone to teach – we’re looking for someone who knows how to do it.

We received about 600-700 applications, including one guy who recommended his four-year-old son. We’re heard from lots of good people, but the key is whether they could do it running \$100 billion. We want to find someone who can run large sums of money mildly better than the market – and I emphasize mildly because there’s no way anyone can beat the S&P 500 by 10 percentage points per year [running such a large amount of money]. It isn’t going to happen. But a few percentage points per year is possible.

Anything times zero is zero and I don’t care how good the record is in every other year if one year there’s a zero. We’re looking for someone who is wired in such a way as to see risks that haven’t occurred and be cognizant of risks that have occurred. Charlie and I have seen guys go broke or close to it because 99 of 100 of their decisions were good, but the 100th did them in.

We want to give them each a chunk of about \$5 billion and have them manage it for a period of time, as if they were managing \$100 billion. Then [after watching them and evaluating them for a while], we’d turn over the entire portfolio to one or more of them.

Munger: It reminds me of the young guy who went up to Mozart and said, “I’d like to write symphonies.” When Mozart said, “You’re too young,” the young man replied, “But you were young when you started.” Mozart pointed out, “Yes, but I wasn’t asking anyone else for advice on how to do it.”

Buffett: We’ll find some people. I had to do this years ago when I decided to close the Buffett Partnership in 1969 and had to recommend to my investors where they should put 100% of their money. There were many, many investors with great records, but I chose Charlie, Sandy Gottesman, and Bill Ruane. Charlie wasn’t interested in more partners, but Sandy Gottesman took some individual accounts and those investors have been very happy. Bill Ruane set up a separate mutual fund [the Sequoia Fund], which has also done very well.

So, I identified three people who were conservative, where there was no chance at all that they’d blow up, who were not only terrific investors, but also terrific stewards of capital who would treat investors right. They were my age, which helped – I now have to look at people in a generation where I don’t know many people.

In 1979, I picked Lou Simpson for GEICO. I’d never met him but once I did, it was clear that he’d get an above-average result and there was no chance of a bad result. [Buffett published Simpson’s spectacular record on page 18 of his [2004 annual report](#), showing that Simpson had compounded at 20.3% annually from 1980-2004 vs. 13.5% for the S&P 500.]

I have a job to do and I’ll do it.

Berkshire's Intrinsic Value

Intrinsic value is simply the sum of all future cash flows a business generates between now and judgment day, discounted back at the proper rate. But that's pretty nebulous. To value the businesses we own presently, we try to give you information to make a reasonable judgment about that. We own securities, which are easy to value, and operating businesses. We try to give you the information we use to value them.

Since Berkshire retains all of its earnings, it becomes very important to evaluate what we'll do with earnings over time.

If you'd looked at the intrinsic value of Berkshire in 1965, we had a textile business worth \$12 [per share], but that wasn't all. You had to evaluate not only the business, but also the skill with which retained earnings would be used.

It's the same situation today: we will put to work billions of dollars this year and in the future. If we do this effectively, each dollar has a value of more than \$1. We have \$80,000 [per share] in marketable securities. If our insurance business breaks even, that's free to us. We're trying to add to our collection of operating businesses and they'll add to earnings.

If Charlie and I wrote down our estimates of Berkshire's intrinsic value, they wouldn't be exactly the same, but they would be close.

Overseas Investing

We have a bias toward investing in the U.S., but I bought my first stock outside the United States at least 50 years ago and we've looked at plenty of marketable securities overseas. It would make no difference to us if Coke was headquartered in Amsterdam.

But nobody outside the U.S. has heard of us. Eitan Wertheimer found us. The Iscar acquisition has contributed to our becoming better known. Eitan is going through a procedure to get us better known abroad. [Buffett did not give any details about this "procedure".]

I haven't done a good selling job abroad. We could be fairly criticized for not doing enough to become better known [overseas].

We own stocks in Germany and 4% of POSCO, which is based in South Korea – it's now worth over \$1 billion. I can think of a half dozen investments [we currently have] outside the U.S. We don't have to report them in our [SEC Form] 13F, so they don't get picked up like our domestic investments.

We have to report our holdings in Germany once we reach 3% ownership. So if we buy a \$10 billion [market-cap] company, that means once we buy \$300 million worth we have to tell the world, and Charlie and I don't like doing that. It screws up our future buying, so the 3% rule is a real minus.

I can assure you that the entire world is on our radar screen and we hope to be on its radar screen.

Munger: John Templeton made a fortune being in Japan very early and stocks there went to 30-40x earnings. It was an admirable piece of investment, but you know, we did alright during the same period. [Laughter]

Does the big increase in Q1 equity purchases indicate a lowering of your threshold for investment?

[My partner Glenn Tongue asked this question, referring to Berkshire's purchase of \$5.3 billion in equities in the first quarter of 2007, vs. \$1.5 billion in last year's Q1.]

Did we change our standards? You know, I don't think so, but you can't be 100% sure. If you haven't had a date for a month, you might say you wouldn't have dated that girl on the first day – but I think we would have.

It does not reflect our giving up on finding an elephant of a business to acquire. We have plenty of cash and could sell stocks if we really needed to. We're well prepared to acquire a very large business.

We acquired TTI in the first quarter [[here](#) is Berkshire's press release], which is a terrific business. We wish it were five times bigger, but maybe some day it will be.

Munger: The one thing I think we can promise you is that we won't make the kinds of returns buying the things we are now that we earned on the stuff we bought 10-15 years ago. There's just too much money floating around.

Buffett: We won't come close.

Munger: It's a different world with more modest expectations.

Buffett: We hope you share them.

Where is best place to invest going forward, with tight credit spreads, large trade deficits, etc.?

We think we're in a pretty good group of businesses for the world we face. We don't know which will be super-winners, but we think a significant number will do okay. We don't buy businesses with much thought of world trends, but we *do* think about businesses subject to foreign competition, with high labor content and a product that can be shipped in.

I bought into an airline [US Air] with high seat-mile costs of 12 cents. It was protected, but that was before Southwest showed up with 8-cent costs.

The variables you name don't bother us. We have good businesses, deal from strength, *always* have a loaded gun and have the right managers and people and an owner-oriented culture.

Munger: We learned about foreign labor competition in our shoe business. It reminds me of Will Rogers, who said he didn't think man should have to learn easy lessons in such a hard fashion. You should be able to learn not to pee on an electrified fence without actually trying it. [Laughter]

How often do you review each position in your portfolio? Some look every day, sometimes more, some once a year. What is your frequency?

Buffett: It breaks down into two periods of my life: when I had more ideas than money, I was constantly reviewing my portfolio, figuring out which stock to unload to buy a new one.

Today, I have more money than ideas so we aren't really thinking of selling when the alternative is cash. But we're always collecting information on every company we own – it is a continuous process, but not with the idea that daily, weekly or monthly activity will result.

If we needed money for a very big deal, \$20-, \$30- or \$40-billion, and we had to sell \$10 billion in equities, we'd use information we've been collecting daily to decide what to sell.

Munger: Even in Warren's early days, he wasn't thinking about his #1 choice [his single favorite stock] – he could put that aside [because he'd never sell it].

Adding to Existing Positions

We think about adding more to certain stocks and have done so. We add to ones that look attractive and that we can buy. If you look at the portfolio at the end of 2007 you'll see that certain positions have been increased by billions of dollars. We like many of our positions and if they get cheap, we'll buy more.

Sometimes there's not enough stock or we might cross certain thresholds that cause reporting requirements or going above 10%, which triggers the [short-swing rule](#).

Munger: It's not as easy as it looks to buy these big positions. When we were buying Coca-Cola, we bought every share we could – we bought 30-40% of the volume, yet it still took us a *long* time to accumulate our position. However, we like it better when we have these problems now than when we didn't earlier.

Buffett: We usually feel we can buy 20% of the daily volume and not move the market too much. That means if we want to buy \$5 billion, we have to wait for \$25 billion to trade and not a lot of stocks trade that much.

What are your views of the future profitability of the railroad industry?

I don't think the railroad industry will be a lot more exciting, but the competitive position of the railroads has improved somewhat since 20 years ago. There's been progress on labor issues and an improved competitive position vis-à-vis truckers. Higher oil prices hurt railroads, but hurt truckers more by a factor of four. What was a terrible business 30 years ago, operating under heavy regulation, has become decent and could be better over time. But it will never be a fabulous business – it's too capital intensive.

Investing in Silver

I'm not sure who we sold our silver too, but whoever bought it was a lot smarter than I was. I bought it too early and sold it too early, but other than that it was a perfect investment. [Laughter] Charlie had nothing to do with it – it was all me.

Munger: I think we demonstrated how much we know about silver. [Laughter]

Buffett: When we bought it, we got a lot of letters about conspiracy theories of one sort or another. Silver responds to supply and demand, like any commodity, which is what determines its price (although the Hunt brothers changed that for a short while and regretted it).

Have you considered investing in metals to protect the company against inflation?

We would not necessarily view metals investing as protection against inflation. The best protection is your own earnings power, whether the currency is in seashells or paper money. A first-class surgeon or teacher will do alright in terms of commanding the earning power of other people. The second best protection is owning a wonderful business, not metals or raw materials or minerals.

The truth is, if you own Coca-Cola or Snickers bars or anything that people are going to want to give a portion of their current income to keep getting, and it has low capital-investment requirements, that's the best investment you can possibly have in an inflationary world.

But an inflationary world is not a good thing. We try to own good businesses. I think Berkshire wouldn't do as well in real terms during periods of high rates of inflation vs. low rates, but we'd probably do better than most businesses.

Partners

We normally don't want to do deals with partners. If we like a deal, we want to do it all. We have a lot of money, so we don't need a money partner. As for a knowledge partner, we don't want to do a deal where we're relying on someone else. We've made a few exceptions, but very few. Charlie, can you think of any?

Munger: You did something with Leucadia, but they brought us the deal. [[Click here](#) for an article about this deal.]

Buffett: That's right. They were great. But they invited us to participate in their deal. We came in on the same terms they had. In general, we don't partner with others on deals, but I'd do another deal with Leucadia if they came to me and I liked the deal. That was a very good experience.

COMMENTS ON FINANCIAL COMPANIES AND RISKS IN THE FINANCIAL SYSTEM

How dangerous are derivatives to the financial system and what can be done to mitigate potential damage from them?

[This was my question.]

We've tried to mitigate it [raise warning flags about the dangers of derivatives] a little by talking about it, but realize there is nothing inherently evil about derivatives. We have at least 60 of them and will be discussing them at our upcoming Berkshire board meeting.

Derivatives are expanding rapidly, in more and more imaginative ways. They introduce invisible leverage into the system. In the 1930s, after the crash, the government concluded that leverage contributed to the crash and that it was dangerous. So the U.S. government empowered regulators to deal with this. For decades, they policed it and it was taken seriously when the Fed increased or decreased margin requirements.

But the introduction of derivatives has made any regulation of margin requirements a joke. The regulation still exists, but it's an anachronism.

I believe that we may not know when it becomes a super danger or when it will end precisely, but I believe it will go on and increase until very unpleasant things happen because of it.

You saw one example of what can happen under forced sales in October 1987. It was driven by portfolio insurance, which was a joke. It was a bunch of stop/loss orders, but done automatically, and it was merchandized. People paid a lot of money for people to teach them how to put in a stop/loss order. When a lot of institutions do this, the effect is pouring gas on a fire. They created a doomsday machine that kept selling and selling.

You can have the same thing today because you have fund operators with billions of dollars – in aggregate, trillions of dollars – who will all respond to the same stimulus. It's a crowded trade, but they don't know it and it's not formal. They will sell for the same reasons. Someday, you will get a very chaotic situation.

As for what could trigger this and when, who knows? Who had any idea that shooting an archduke would start World War I?

Munger: The accounting being enormously deficient contributes to the risk. If you get paid enormous bonuses based on profits that don't exist, you'll keep going. What makes it difficult [to stop] is that most of the accounting profession doesn't realize how stupidly it's behaving. One person told me the accounting is better because positions are marked to market and said, "Don't you want real-time information?" I replied that if you can mark to market to report any level of profits you want, you'll get terrible human behavior. The person replied, "You just don't understand accounting."

Buffett: When we went to close out Gen Re's derivatives book, we took a \$400 million loss on a portfolio that was "marked to market" by the prior management and auditors – and I'm not criticizing our auditor. Any auditor would have said the same. I wish I could have sold to the auditors instead!

Take a dry cleaning business that owes \$15. Their books show a \$15 accounts payable and the other company shows an offsetting \$15 accounts receivable. But there are only four big auditing firms, so in many cases, if they're auditing my side, the same firm may be valuing or attesting to the value of what's on the books of the person on the other side. I will guarantee you that if you add up the marks on both sides, they don't add up to zero. We have 60 or more derivative contracts, and I'll bet the other side isn't valuing them like we are. I have no reason to mark the value up – we don't get paid for that. If I value it at \$1 million on our side, the other side *should* be marking it at minus \$1 million, but I guarantee the numbers are widely different. Auditors should check both sides of derivative trades and the "marks" should sum to about zero. They don't.

Munger: As sure as God made little green apples, this will cause a lot of trouble. This will go on and on, but eventually will cause a big dénouement.

The Electronic Herd

Buffett: If you take the percentage of bonds and stocks held by people who could change their minds tomorrow based on what the Fed does, etc., it's gone up a lot. I call it an electronic herd, who change what they do every day or minute. The turnover of stocks has gone from 40% to over 100%, and the turnover of bonds has gone up dramatically as well. There's nothing evil about it, but it's a different game and there are consequences. If you're trying to beat the other fellow on a day-to-day basis and you're watching the news or the other fellow, and you think he's going to push the sell button, you'll try to push it quicker.

When Charlie and I were at Salomon, they talked about 5- or 6-sigma events, but that doesn't mean anything when you're talking about real markets and human behavior. Look at what happened in 1998 and in 2002. You'll see it when people try to beat the markets day by day.

When I set up my partnership [the Buffett Partnership], I told my partners they'd hear from me once a year.

Munger: When people talk about sigmas in terms of disaster probabilities in markets, they're crazy. They think probabilities in markets are [Gaussian distributions](#), because it's easy to compute and teach, but if you think Gaussian distributions apply to markets, then you must believe in the tooth fairy. It reminds me of when I asked a doctor at a medical school why he was still teaching an outdated procedure and he replied, "It's easier to teach." [Laughter]

Buffett: It's very disturbing to spend years learning higher mathematics and then learn that that stuff has no utility or that there's even counter-utility. It's hard to change, so people just keep on teaching [incorrect things].

The Likelihood of a Major Credit Contraction

It occurred during the junk bond crisis in 2002 and for equities in 1974.

I don't think you'll necessarily see a contraction of credit or the Fed stepping on the brakes. I think you might see an exogenous event, a shock to the system, that causes a huge widening of credit spreads and a cheapening of equities. This would be good for Berkshire because we have money to take advantage of this.

In the past, when credit contracted, there was no money around. We tried to buy a bank in Chicago 30 or 40 years ago and couldn't borrow at all. The only people willing to lend to us were in Kuwait, and would only lend in dinars. That was *real* credit contraction. The reason the Fed was established was in response to this. We really needed a system where that would not happen. I think the Fed will not by design produce any credit contraction.

Munger: The last time we had a credit contraction [in the junk bond crisis in late 2002], we made a quick \$3-4 billion. The whole investing world is getting more and more competitive. If we had a big credit contraction, it would really gum up the world. If we had this, especially after a period of excess like we've had, we'd get legislation that most of us wouldn't like.

Buffett: Jon Alter, in his book about the Great Depression [[The Defining Moment: FDR's Hundred Days and the Triumph of Hope](#)], describes how this country was close to the brink and FDR got any law passed he wanted, as soon as he could write them. It was a good thing in this case – banks were closing and people were dealing in scrip.

In 1998, Long Term Capital Management blew up and you had a seize-up of the credit markets that was not orchestrated by the Fed. People panicked about even the safest instruments. This happened not 100 years ago but less than 10 years ago. There were plenty of smart people with a lot of money, but people panicked in part because they saw others panicking.

History doesn't repeat itself, but it rhymes. We'll have something that rhymes.

Comments on the Subprime Market

The subprime market, encouraged by lenders, intermediaries, builders, etc., led to a lot of people buying houses they couldn't afford. There will be consequences for these people, but the question is whether it spreads. If unemployment and interest rates don't go up, then it's unlikely this factor alone triggers anything in the general economy.

In the 10Qs and 10Ks I've read, a high percentage of loans allowed people to make tiny payments early on, made up by higher payments later. I think this is dumb lending and dumb borrowing because someone who can only make 20-30% payments now isn't going to be able to make 110% payments in the future. Those people and institutions were betting that house prices would keep going up. When this stops, you have a big supply of houses come on the market, like we saw in manufactured housing. You'll see plenty of misery in that field – you've already seen some. But I don't think it'll be any huge anchor for the economy.

Munger: There's been a lot of sin and folly, a lot of it due to accountants who let lenders book profits when no one in their right mind would have allowed them to book profits. If accountants lie down on the job, you see huge folly.

It's in the national interest to give loans to the deserving poor. But the moment you give loans to the undeserving poor or the stretched rich, you run into trouble. I don't see how people did it and still shaved in the morning, because looking back at them was a face that was evil and stupid.

Buffett: You've seen some very interesting figures in the past few months on people who didn't even make the first or second payment. That shouldn't happen. We saw this in the manufactured-home sector. When someone only has to make a \$3,000 down payment to someone who gets a \$6,000 payment [the salesperson's commission], then believe me, you'll see a lot of bad behavior.

Securitization accentuated the problem. A local banker wouldn't allow this because he'd see what's going on, but when the loans are bundled and sold by Wall Street, that discipline disappears.

It will be at least a couple of years before real estate recovers. In some areas of the country, the [housing] inventory overhang is huge. The people who were counting on flipping the homes are going to get flipped, but in a different way.

Comments on Managed Futures

[The question was asked by Christian Baha, the founder of Superfund, a *highly* suspect outfit in my opinion. Click [here](#) to read a 2006 *BusinessWeek* article about Superfund. The two funds open to U.S. investors, Quadriga Superfund A and B, charge unbelievable fees (6.75% and 8.62% annual fees, respectively, *plus* 25% of the profits), are hugely volatile, have trailed the S&P 500 badly since their launch on 11/1/02 and are down big this year.]

[Buffett initially appeared not to understand who was asking the question and why, but Munger knew...]

We think the most logical fund is like the one we manage at Berkshire, where we can do anything, but are not compelled to do anything. We would not limit ourselves to one area of the market – we buy stocks, futures, bonds, currencies, entire businesses, etc. We think it's a mistake to shrink the universe of opportunities.

There's no *form* that produces good investment results, be it hedge funds, private equity funds or mutual funds. What makes the difference is whether the people running them know their strengths and weaknesses and play when it is to their advantage and do nothing when it is not.

Munger: I'd say that, averaged out, returns [on managed futures] will be somewhere between lousy and negative over time.

Buffett: I'd agree. These funds are sold. Someone will sell them. I think it's a mistake to say, "Here's a great area of opportunity." Brains make an area of opportunity.

COMMENTS ON BUSINESS AND ECONOMIC MATTERS

Executive Compensation

Munger: The question is about the unfairness of executive compensation and the effect on investors. Now that you know the question, you can solve it.

Buffett: There are more problems with having the wrong manager than the wrong compensation system. It's enormously difficult to run a big company, so the greater sin is having the wrong person [as CEO vs. overpaying that person].

There is a natural tendency toward rising compensation due to ratcheting, the publicity of what other CEOs get and the lack of intensity of the bargaining process. You read about labor negotiations going on for weeks, both sides declare an impasse, they negotiate until 3 am, etc. When was the last time you heard about anything like this when a board negotiates pay with a CEO? There's not parity in the negotiating process – one side really cares and the other doesn't.

Comp consultants know that getting hired in the future depends on a recommendation from the CEO. Under those circumstances, it's an unfair fight. It's a joke.

I've been on 19 boards and they put me on one comp committee – and they regretted it. They're looking for cocker spaniels, not dobermans. I try to pretend I'm a cocker spaniel, but nobody's fooled. [Laughter]

What really drives it is envy, not greed. You pay someone \$2 million and they might be quite happy until they hear that someone else got \$2.1 million.

Charlie said of the seven deadly sins, envy is the worst because it makes you miserable. The other guy doesn't care. Compare this to gluttony, which we're about to do [referring to the See's candy in front of them]. I've heard good things about lust, but I'll let Charlie address that. [Laughter]

Compensation is not rocket science. We have very simple systems to compensate our people. We don't make it complicated. We don't pay them for things that are happening that they have nothing to do with.

If oil goes from \$30 to \$60, there's no reason to pay [an oil company executive] for that. If they have low finding costs, which they can control, I'd pay them like crazy for that. *That* is the job you hire them for. To hand them huge checks for something they have no control over is crazy, and it's equally crazy to penalize them if oil prices go down. If oil prices went down and my CEO had low finding costs, we'd pay him like crazy.

Munger: This process has contributed to the rise of comp consultants. It reminds me of the joke about why the woman told the census taker that the man of the house was in jail for embezzlement. Because she didn't want to admit that her dad was a comp consultant. [Laughter]

Boards of Directors

Most writers and shareholders probably have a little bit of a distorted view of how most large corporations have operated over the years. For a long time, most directors were sort of like potted plants. Management had its agenda and didn't want input on major matters and Charlie and I can testify that we've had very little success in influencing big issues. If someone's spent 20-30 years rising to become CEO, they don't want a board telling them what to do. It's changed a little bit today in terms of process.

Overwhelmingly, the most important job of the board is to pick the right CEO. If you were on the board of Cap Cities and you hired Tom Murphy, case closed.

The second most important job of a board is to prevent the CEO from overreaching. A board should bring independent judgment on acquisitions. There's a natural tendency for CEOs to want to become bigger by spending other people's money. [See [this](#) recent article in the *New York Times* about this phenomenon.] The deal is already done by the time the board knows about it. The investment banker comes in and I've never seen a banker say, "This is a dumb idea."

When a significant deal comes along, it's a chance for the board to weigh in and discuss the economics of what's going on. But the CEO doesn't bring a deal unless he wants it done and so he stacks the deck.

Munger: I think big deals, on average in America, are contrary to shareholders' interest.

Buffett: In most stock deals, the CEO thinks about what he's getting, but not what he's giving. You have to make sure you think about this. I can't ever think of a discussion [when I was on a board] of weighing what you're giving away vs. what you're getting in a stock deal. If more value is being given away, then don't do it! When I gave away 2% of Berkshire to buy Dexter shoes, it was one of the dumbest things ever. Not 2% of Berkshire then, but 2% of Berkshire today!

Munger: Fortunately, you've made some good decisions.

Buffett: Or half of you wouldn't be here. It gets swept under the rug.

We owned a bank that went to acquire a smaller bank. The CEO of the smaller bank held out for a high price and various terms and conditions and, because he was taking stock, had one last condition for the acquiring bank: "Promise never to do a deal this dumb in the future." [Laughter]

I've been on some terrific boards. The best was probably a local business, Data Documents. Every board member had a significant percentage of his net worth in the company and every decision was made for business reasons.

In contrast, the standard now is when deal is possible, trot in the investment bankers. I know the answer: they always say, "This is a great deal."

At Berkshire, almost everyone on the board has a lot of Berkshire stock. They're in the same position as shareholders. They don't have D&O [Directors and Officers] insurance and they bought the stock in the open market. It's a real owners board.

If you were to follow up on your *Fortune* article from 1999 about the lean and fat periods ([Mr. Buffett on the Stock Market](#)), what would you be writing? You talked about 17-year periods. How is it turning out now, since we're halfway through the next one?

There's nothing magical about 17-year periods – I just had a little fun with it because there were two 17-year periods, and there are 17-year locusts.

In 1999, people were extrapolating from the experience of the previous 17 years and had unrealistic expectations. They were bound to be disappointed

If I were writing something now, I'd say I'd have expectations beyond 4.75% – I don't know how much more, but more for sure. I would not have high expectations for equities, but better than for bonds.

Munger: Since that article was written, the experience from owning equities has been pretty lean, so Warren's been right so far and I suspect is right now to have modest expectations.

Buffett: It's hard to be right every day or week or month – that's what happens if you're on TV too often. [He mentioned 1974 and a few other years in which he made market predictions; I wrote a column about this in 1999, [Buffett's Prescient Market Calls](#), suggesting my readers heed Buffett's warning in the *Fortune* article. Incidentally, Buffett's Market Call #5 highlighted in my article proved to be particularly correct: from 1993-2002 the S&P 500 compounded at 9.4% annually, far less than the 16.1% of the 10 previous years]. But every now and then, things really get out of whack. But the gradations in between are too tough. If you own great businesses, you should just hold on most of the time, maybe sell if the valuations get extremely high and buy more if they get really cheap like in the early 1970s.

Future Returns from Stocks

When I closed the Buffett Partnership, I felt (and wrote to my investors) that the prospective return was about the same for equities and municipal bonds over the next decade, and I was roughly right. It's not the same today. I'd have 100% of bonds in short-term bonds. Forced to choose between owning the S&P 500 vs. 20-year bonds, I'd buy stocks – and it would not be a close decision. But I wouldn't have an equity investment with someone who charged high fees.

We don't have the faintest idea where the S&P or bonds will be in three years, but over 20 years we'd prefer to own stocks.

Munger: We think there will be a disruption not too many years ahead.

Buffett: Of course, you could have said that and have been right at any point in the past century – there are always disruptions – but stocks have still done well. We'd rather have good stocks than sit around and hope they get cheaper, so anytime we see something good, we buy, hopefully in size.

Are corporate profit levels sustainable?

Corporate profits as a percentage of GDP are at a record. I've been amazed. After being in a range for decades, it's jumped up. I'd have to look at a chart, but other than maybe a year after World War II, I think there have only been two or three years in the past 75 where corporate profits have been as high [as they are today]. I would not think it would be sustainable. When they get up to 8% or more of GDP, that's high, but so far there's been no reaction like higher taxes.

You have lots of businesses earning 20% on tangible equity in a world where corporate bonds are yielding 4-5%. That's astonishing. If you read a book, it would say it's not possible. This is high, which means someone else's share is going down, namely labor's. Does it become a political issue? Congress has power to change this very quickly. Corporate tax rates used to be 35%, but now many companies are paying only 20%.

Corporate America is living in a great time. History shows this is not sustainable. I would imagine that it will not be.

Munger: A lot of profits are not in manufacturing or retailing, but in financial sectors. There's been a huge flow of profits to banks and investment banks. That has no precedent. I don't think it's ever been as extreme as it is now.

Buffett: We've invested in and owned banks. If 20 years ago you'd asked me whether it was possible, in a world of 4.75% bonds, that countless banks would earn 20%+ returns on tangible equity, I'd have said no. In part this is due to leverage. A 1.5% return on assets leveraged 15 times is a 22.5% return on equity. But even so, you'd think once everyone was doing it, return on assets would drop to 1%, but it hasn't happened yet.

Munger: Some of this is due to consumer credit, which has been pushed to extremes. Other countries that have done this have suffered bad consequences – South Korea, for example, really suffered for two or three years. I don't think this is a time to swing for the fences.

Buffett: In South Korea, it produced some of the cheapest stock prices I've ever seen.

Is the private-equity boom a bubble?

We're competing with those people, so I started to cry, thinking about the difficulty of finding things to buy.

Due to the nature of private equity, it's not a bubble that will burst. They lock up their money for 5-10 years and buy businesses that don't price daily. It takes many years for the score to be put on the board and the investors can't leave. It's not like leverage in marketable securities.

What would slow it down is if the spread between high-yield bonds and safe bonds widens. This would slow down deals, but won't cause investors to get their money back.

There's another factor: if you have a \$20 billion fund and get a 2% fee, you're getting \$400M a year. But you can't raise another fund with a straight face until you've invested it, so there's a great compulsion to invest it quickly so you can raise another fund and get more fees.

We can't compete against these buyers. We buy forever and it's our own money. I think it will be quite some time before disillusion sets in [among the investors in private-equity funds].

Munger: It can continue to go on for a long time after you're in a state of total revulsion. [Laughter]

Buffett: The voice of total optimism has spoken. [More laughter]

View on Commodities

We have no opinion on commodities. If we're in an oil stock, it means we think it offers a lot of value at this price. If we think oil is going up, we could buy oil futures, which we did once.

We think Posco is the best steel company in the world. When we bought it, it was at 4-5x earnings, had a debt-free balance sheet and was the low-cost producer.

You can find some businesses with minimal capital investment. See's Candy does not require much capital investment. It's a small business, but a wonderful business – a far better business, adjusted for size, than any steel or oil business. We do everything we can to make it bigger.

We do not have a bias toward any commodity-related business. If we have any bias, it's against.

Munger: We're going to be investors in businesses, not commodities, and that has to work better over time.

What advice do you have for long-suffering New York Times shareholders and what do you think of its dual-class share structure?

As for the “long suffering”, as you put it, shareholders of the New York Times, I don't blame the Sulzbergers for what's happened. [[Here](#) is the bio of Arthur Sulzberger Jr., the Chairman and Publisher of the New York Times Co., and [here](#) is a 2005 *BusinessWeek* article about the family, the company and the challenges they face.] We've said for a long time that we thought newspapers were overpriced because investors were looking in the rear-view mirror.

As for different share classes [which the NYT has], I own about 30% of Berkshire A and B shares, so there's no voting difference.

The woes of the newspaper business have nothing to do with the dual-class structure.

Let's suppose Mr. Gutenberg [[Johannes Gutenberg](#) was the inventor of modern printing] in the 1500s [actually 1400s; he lived 1400-1468] had become a day trader or hedge fund manager instead, so that we never had printing. But along came the Internet and cable TV [as we have today]. Now imagine that someone came along saying, “I have a great idea: let's chop trees down, buy expensive printing presses and buy a fleet of delivery trucks, all to get pieces of paper to people to read about what happened yesterday.” I don't think we'd be backing him. [Buffett's point is that if newspapers didn't exist, no one would create them now.]

It happened that newspapers came first and people have become accustomed to them. They have momentum on their side from the past, but I don't care how smart you are, you're not going to be able to do much to reverse their decline.

Some smart guy came to the *Los Angeles Times* and said he was going to take circulation up to 1.5 million. Well, it's now at 800,000. I don't know if even [William Randolph Hearst](#) could do much to change this.

The same thing happened to us with the [World Book Encyclopedia](#) – its sales have dropped from 300,000 to 22,000.

The companies that have not had dual-class structures have fared just as badly. For example, we own [The Buffalo News](#), and earnings are down 40% from the peak. Despite terrific management and high market share, earnings are going down. It's a fact of life.

Munger: He said the dual-class structure is intrinsically wrong. It was in the original contract when the New York Times Co. went public. Stamping your foot if you don't like it strikes me as immature.

Buffett: Sulzberger [Arthur Sr.] would not slash staff and did not follow the typical business school approach – and look at his success. All the others fell by the wayside. I don't know if 10-15 years from now, the *New York Times* will be viewed as having played an inferior hand.

The *Los Angeles Times* will have more trouble monetizing their reputation on the Internet when compared to the *New York Times*.

Thoughts on Gambling Companies

I don't know about which stocks to recommend, but, as long as we're talking about the legal ones, gambling companies will have a perfectly good future. The desire of people to gamble is very high, including in stocks. Day trading comes very close to gambling. People like to gamble. If there's a football game, especially if it's boring, you'll enjoy it more if you bet a few bucks. The human propensity to gamble is huge.

When it was only legal in Nevada, you had to travel or break laws to gamble, but now states are legalizing it. The easier it is, the more people who will gamble. I bought a slot machine a long time ago and put it on the 3rd floor of my house. I could then give my children any allowance they wanted, as long as it was in dimes, and I'd have it all back by nightfall. I wanted to teach them a good lesson. My slot machine had a terrible payout ratio, by the way. [Laughter]

People will always want to gamble. I'm not a prude about it, but to quite an extent, gambling is a tax on ignorance. You just put it in and guys like me don't pay the taxes – it relieves taxes on those who don't gamble. I find it socially revolting when a government preys on its citizens rather than serving them. A government shouldn't make it easy for people to take their social security checks and [waste them pulling] a handle. It's not government at its best. I think other [negative social] things flow from [gambling] over time.

Munger: I would argue that casinos use clever psychological tricks [to get people to gamble], some of which are harmless, but a lot of grievous injury has been done. You won't find a lot of gambling companies in Berkshire's portfolio. [Applause]

Are China's banks today like Japan's before the bubble burst?

I don't know if China's banks are like Japan's before the bubble. I don't know anything about Chinese banks. I can't make any decision here.

Munger: If you stop to think about all of China's remarkable economic progress over the past 15 years, it has occurred *despite* the banks doling out money for aid as distinguished from normal banking. I'd be very leery of predicting that there will be a banking crisis. They've been doing it for a *long* time and may be getting better.

Buffett: We've had various banking crisis here and it's produced some dislocations, but if you look at the American economy, it's come through all sorts of real financial crises with GDP per capita rising every decade.

Are corporate jets a waste of shareholders' money?

I want to report that we're solidly in favor of private jets. [Laughter]

Charlie used to travel by bus, and only when they had a senior discount. In recent years, I've shamed him into getting a NetJets share; I have two. Berkshire is better off because we use corporate jets. I don't know which deals wouldn't have been made, but I do know [that without a private jet] I would not have had the enthusiasm to travel thousands of miles to see deal after deal. It's a valuable business tool.

It can be misused like everything else. I remember that one time we invested in a company and the CEO stopped in Omaha to see me. He used a grocery chain in Idaho to test products, but also had a lodge there. Properly used, corporate jets have been a real asset to Berkshire.

Munger: If the trappings of power are greatly abused, I think you would find those companies would be disappointing to investors. The Roman emperor who was best remembered was [Marcus Aurelius](#) – he had no trappings of power, though he could have. The best way to combat [the excesses of leaders] is to have examples of exemplary behavior.

Florida's Insurers Problems with the State Government

It's easy to understand both sides. The average homeowner will not read line by line of an insurance policy and the agent often won't explain it. So when something goes wrong, the homeowner wants to be paid. It's worse when tens of thousands of homeowners are affected at the same time. It's natural for

government to step in and expand what an insurance company thought they were covering, which leads insurance companies to pull out.

I can understand the insurance company not wanting to write policies if the words won't be adhered to, and I can understand the upset homeowner. If I were writing policies, I'd put exclusions in big type, but even so, I'd expect courts and legislatures to extend or even abrogate the terms of the contracts, figuring a guy like me or insurance companies can better afford it vs. the people affected.

When you have people around the country subsidize people who suffer from hurricanes in Florida, that gets very tough. It might become so expensive that they want to socialize it, but the guy in Nebraska says "Why should I subsidize you living in a hurricane path?"

It will really become an issue if you have a \$100 or \$150 billion loss in Florida. This would lead to a huge increase in taxation in Florida, so the state might call on Washington [the federal government] to pay for it [Florida is already doing so, as [this](#) blog post details]. How much should people who are not exposed to risk send to people who choose to have this risk? I think you'll see a big struggle over this in the next 10 years.

The State of Florida getting into the Insurance Business

I can't tell you with precision what the Florida legislation says, but the state of Florida has gotten more into the business of insuring citizens than it was before.

[Buffett asked Joe Brandon, CEO of Gen Re, to take the microphone and answer the question.]

Brandon: Back in mid-January, the Florida legislature met in a special session and passed legislation that is moving a lot of risk in personal lines. It is having a depressing effect on the insurance industry. There is no free lunch. The state and citizens of Florida are taking a lot of risk. It will work out well if the wind doesn't blow, but odds are that it will. [According to [this](#) summary of the legislation, the state has taken on a \$12 billion increase in exposure from \$16 billion to \$28 billion, with the possibility of an additional \$4 billion more.]

Buffett: The real problem will be with a \$100 billion insured loss. The state might have to issue \$60 billion in bonds and might go to the federal government and say, "It's not our fault and the entire country should pay." \$100 billion isn't likely – Hurricane Andrew, inflation adjusted, was \$30 billion – but if that storm had come through 20 miles north, it could have been. If this happens, we'll find out if the whole country has, in effect, been insuring Florida. If the federal government throws it back to Florida, they'd have to issue a lot of bonds and raise taxes.

Comments on Shorting and Naked Shorting

I've never been in a position to ask a broker from whom I've bought to deliver the shares and not had it happen.

I don't see the problem of people shorting stocks, assuming they're not manipulating the market. I would welcome people wanting to short Berkshire. In fact, I'd lend them stock and earn extra income. They're a certain future buyer.

If anyone wants to naked short Berkshire, they can do it until the cows come home. In fact, we'll hold a special meeting for them. [Laughter]

The shorts generally have a tougher time of it in this world. More people are bullish on stocks. It's a tough way to make a living. It's very easy to spot a phony stock or a heavily promoted stock, but it's hard to say when it will turn. If it's trading at five times its intrinsic value, there's no reason it can't trade at ten times.

I don't see shorts as any great threat to the world. If a lot of people want to short your stock, they have to pay you [for the borrow]. We did this with USG. One large brokerage firm approached us [about lending out our stock] and we were happy to do this. We charged them a lot. We even forced them to hold it for a certain period of time so we could continue to earn money on the borrow.

Munger: There's tremendous slop in the clearance process. It's not good for a civilization. It's like having slop in the management of your nuclear power plants.

Buffett: If I buy 1,000 shares of GM and ask my broker to deliver it and he doesn't, what's the situation?

Munger: If you're a private customer, you have to wait a while. There's a lot of slop in derivative trading.

Buffett: But can't I take my broker to court after three weeks?

Munger: I don't think that there's any court that can give you a stock certificate just because you want it.

Thoughts on the EuroNext-NYSE Merger

[Here](#) is an article about the merger]

I don't really have an answer. EuroNext and NYSE are both large institutions. Both places have been very efficient in the past. The NYSE has gotten far more efficient in terms of costs – a fraction of the costs relative to the early 1970s. The real question is whether they get more efficient once they're together and, if so, whether they pass along the savings or just increase their profits. We're quite satisfied with the functioning of the NYSE and we've done business around the world. It's not a source of concern or enthusiasm for us.

Munger: I don't know anything about it.

Buffett: I don't either – I just took longer to say it.

Declining U.S. Dollar

We think the dollar, over time, unless policies change in a major way, will likely decline somewhat more against most major currencies. At one time, we backed this up with \$22 billion in foreign currencies, but then the carry made that an expensive way to express that belief, so now we buy into companies that earn a lot in foreign currencies. It's a factor, but not a 50% factor, in what we buy.

We're following policies in this country that will lead to a decline in the dollar – the fundamental forces are fairly strong.

We own one currency position right now that will surprise you – we'll tell you about it next year.

Munger: The inflation factor at Costco is zero. It's perfectly amazing how well we've done so far.

Buffett: Look at oil going from \$30 to \$60 and the euro from 83 cents [per dollar] to \$1.35, so the price of oil for Europeans has gone up very little – 25% vs. 100% for us. It's easy to anchor on your own currency.

You'll have to think more about currency than you have. Around the world, others think about currencies, but the average American hasn't had to.

INVESTMENT ADVICE

Approach to Buying Businesses

We favor businesses where we really think we know the answer. If we think the business's competitive position is shaky, we won't try to compensate with price. We want to buy a great business, defined as having a high return on capital for a long period of time, where we think management will treat us right. We like to buy at 40 cents on the dollar, but will pay a lot closer to \$1 on the dollar for a great business.

If we see someone who weighs 300 pounds or 320 pounds, it doesn't matter – we know they're fat. We look for fat businesses.

We don't get paid for the past, only the future [profitability of a business]. The past is only useful to give you insights into the future, but sometimes there's no insight. At times, we've been able to buy businesses at one quarter of what they're worth, but we haven't seen that recently [pause] except South Korea.

Munger: Margin of safety means getting more value than you're paying. There are many ways to get value. It's high school algebra; if you can't do this, then don't invest.

Circle of Competence and Margin of Safety

Munger: When you're trying to determine intrinsic value and margin of safety, there's no one easy method that can simply be mechanically applied by a computer that will make someone who pushes the buttons rich. You have to apply a lot of models. I don't think you can become a great investor rapidly, no more than you can become a bone-tumor pathologist quickly.

Buffett: Let's say you decide you want to buy a farm and you make calculations that you can make \$70/acre as the owner. How much will you pay [per acre for that farm]? Do you assume agriculture will get better so you can increase yields? Do you assume prices will go up? You might decide you wanted a 7% return, so you'd pay \$1,000/acre. If it's for sale at \$800, you buy, but if it's at \$1,200, you don't.

Buffett: If you're going to buy a farm, you'd say, "I bought it to earn \$X growing soybeans." It wouldn't be based on what you saw on TV or what a friend said. It's the same with stocks. Take out a yellow pad and say, "If I'm going to buy GM at \$30, it has 600 million shares, so I'm paying \$18 billion," and answer the question, *why*? If you can't answer that, you're not subjecting it to business tests.

We have to understand the competitive position and dynamics of the business and look out into the future. With some businesses, you can't. The math of investing was set out by Aesop in 600 BC: a bird in the hand is worth two in the bush. We ask ourselves how certain we are about birds in the bush. Are there really two? Might there be more? We simply choose which bushes we want to buy from in the future.

The ability to generate cash and reinvest it is critical. It's the ability to generate cash that gives Berkshire value. We choose to retain it because [we think we can reinvest each dollar to generate more than \$1 of value].

If you were thinking about paying \$900,000 or \$1.3 million for a McDonald's stand, you'd think about things like whether people will keep eating hamburgers and whether McDonald's could change the franchise agreement. You have to know what you're doing and whether you're within your circle of competence.

Munger: We have no system for estimating the correct value of all businesses. We put almost all in the "too hard" pile and sift through a few easy ones.

Buffett: We know how to recognize and step over one-foot bars and recognize and avoid seven-foot bars.

Advice on Becoming a Successful Investor

I think you should read everything you can. In my case, by the age of 10, I'd read every book in the Omaha public library about investing, some twice. You need to fill your mind with various competing thoughts and decide which make sense. Then you have to jump in the water – take a small amount of money and do it yourself. Investing on paper is like reading a romance novel vs. doing something else. [Laughter] You'll soon find out whether you like it. The earlier you start, the better.

At age 19, I read a book [[The Intelligent Investor](#)] and what I'm doing today, at age 76, is running things through the same thought process I learned from the book I read at 19.

I remain big on reading everything in sight. And when you get the opportunity to meet someone like Lorimer Davidson, as I did, jump at it. I probably learned more in that four hours than in almost any course in college or business school.

Munger: Sandy Gottesman [click [here](#) for a brief bio], a Berkshire director, runs a large, successful investment firm. Notice his employment practices. When he interviews someone, he asks: "What do you own and why do you own it?" If you're not interested enough to own something, then he'd tell you to find something else to do.

Buffett: Charlie and I have made money in a lot of different ways, some of which we didn't anticipate 30-40 years ago. You can't have a defined roadmap, but you can have a reservoir of thinking, looking at markets in different places, different securities, etc. The key is that we knew what we didn't know. We just kept looking. We knew during the Long Term Capital Management crisis that there would be a lot of opportunities, so we just had to read and think eight to ten hours a day. We needed a reservoir of experience. We won't spot every one, though – we've missed all kinds of things.

But you need something in the way you're programmed so you don't lose a lot of money. Our best ideas haven't done better than others' best ideas, but we've lost less. We've never gone two steps forward and then one step back – maybe just a fraction of a step back.

Munger: And of course the place to look when you're young is the inefficient markets. You shouldn't be trying to guess if one drug company is going to have a better pipeline than another.

Buffett: You should do well in games with few other players. The RTC [Resolution Trust Corporation; click [here](#) for more on this] was a great example of a chance to make a lot of money. Here was a seller [government bureaucrats] with hundreds of billions of dollars of real estate and no money in the game, who wanted to wrap up quickly, while many buyers had no money and had been burned.

There won't be any scarcity of opportunity in your life, although there will be times when you feel that way.

How Buffett Would Invest with a Small Amount of Money

If I were working with a very small sum – you all should hope this doesn't happen – I'd be doing almost entirely different things than I do. Your universe expands – there are thousands of times as many options if you're investing \$10,000 rather than \$100 billion, other than buying entire businesses. You can earn very high returns with very small amounts of money. Everyone can't do it, but if you know what you're doing, you can do it. We cannot earn phenomenal returns putting \$3, \$4 or \$5 billion in a stock. It won't work – it's not even close.

If Charlie and I had \$500,000 or \$2 million to invest, we'd find little things we could do, not all of it in stocks.

Munger: But there's no point in our thinking about that now.

Importance of Management

Buffett: We've spent many years buying many things without meeting managements at all. The \$5 billion of stocks we bought in the first quarter are mostly run by managements we've never talked to. We read a lot, 10Ks, etc.

If we buy the entire business, we care very much about management and whether they'll behave in the future as they have in the past. We've had good luck with this.

But in marketable securities, we read the annual reports. Charlie and I read an annual report recently – it was very fancy – for an oil company that didn't talk about finding costs per MCF [million cubic feet of gas] or barrel [of oil]. The most important metric, over time, wasn't even discussed and when it was touched on, it was in a dishonest manner. That tells us a lot about the individual running the company. If he's not willing to talk to the owners, even once a year, that makes me question the person. In marketable securities, however, we've still bought into some extremely good businesses run by people we didn't care for because we thought they couldn't screw them up.

Munger: Two things matter: if the quality of the business is good enough, it can carry bad management. The reverse isn't true, though. It's very rare for a great manager to take over a bad business, say the textile business, and make it great. You shouldn't look for Warrens.

Buffett: It took me 20 years [to get out of the textile business]. If you asked me to run a tough business, I wouldn't do it. It's too tough. Even the best manager in the world couldn't fix it. If you gave me first draft pick of all CEOs in America and you said it was my job to run Ford Motor now, I wouldn't do it.

How do you learn who to trust and who not to trust?

I get letters all the time from people who have been taken advantage of in financial transactions. It's sad. A lot isn't fraud – just the frictional costs and the baloney. Charlie and I have had very good luck buying businesses and putting our trust in people – it's been overwhelmingly good, but we filter out a lot of people. People give themselves away and maybe it's an advantage being around awhile and seeing how people give themselves away by what they talk about and what's important and not important to them. We've had a batting average I wouldn't have thought we'd have. We haven't batted 100%, but it's above 90%.

Munger: We're deeply suspicious if the proposition sounds too good to be true. I recall a deal that was pitched to us by someone who said the company only wrote fire insurance on concrete bridges covered by water. It's like taking candy from a baby. [Laughter] We stay away from businesses like that.

Buffett: When they make certain kinds of comments, what they laugh about, if they say "it's so easy." It's not so easy. We rule out people 90% of the time. Maybe we're wrong sometimes, but what's important is the ones we let in. In the 1970s when I referred my clients to three people [as he closed down the Buffett Partnership], when I thought who they should turn over 100% of their money to, there were hundreds of people with great records. I recommended Charlie, Sandy Gottesman and Bill Ruane. I couldn't have told you which of the three would be the best, but the one thing I was sure of was that they were going to be sensational stewards of money and do what was right for clients rather than try to make 2x in commissions in a given year. Anytime someone who takes what I think is an unfair fee structure because they can get it, I rule them out.

Comments on Discount/Hurdle Rates

We don't formally have discount rates. Every time we start talking about this, Charlie reminds me that I've never prepared a spreadsheet, but I do in my mind.

We just try to buy things that we'll earn more from than a government bond – the question is, how much higher? If government bonds are at 2%, we're not going to buy a business that will return 4%.

I don't call Charlie every day and ask him, "What's our hurdle rate?" We've never used the term.

Munger: The concept of a hurdle rate makes nothing but sense, but a lot of people using this make terrible errors. I don't think there's any substitute for thinking about a whole lot of investment options and thinking about the returns from each.

The trouble isn't that we don't have one [a hurdle rate] – we sort of do – but it interferes with logical comparison. If I know I have something that yields 8% for sure, and something else came along at 7%, I'd reject it instantly. It's like the mail-order-bride firm offering a bride who has AIDS – I don't need to waste a moment considering it. Everything is a function of opportunity cost.

Buffett: I've been on 19 boards and seen a zillion presentations projecting a certain IRR [internal rate of return]. If the boards had burned them all, they'd have been better off. The IRR is based on what the CEO wants. The numbers are made up.

Munger: I have a young friend who sells private partnership interests to investors, and it's hard to get returns in that field. I asked him, "What returns do you tell them you can get?" He said "20%." I said, "How did you come up with that number?" He said, "If I told them anything lower, they wouldn't give me the money."

Buffett: There's no one in the world who can earn 20% on big money. It's amazing how gullible pension funds and other investors are. They want it so badly that they'll believe even total nonsense.

Comments on Beta

Volatility does not measure risk. The problem is that the people who have written about and taught volatility do not understand risk. Beta is nice and mathematical, but it's wrong. Past volatility does *not* determine risk.

Take farmland here in Nebraska: the price of land went from \$2,000 to \$600 per acre. The beta of farms went way up, so according to standard economic theory, I was taking more risk buying at \$600. Most people would know that's nonsense because farms aren't traded. But stocks are traded and jiggle around and so people who study markets translate past volatility into all kinds of measures of risk. The whole concept of volatility is useful for people whose career is teaching, but useless to us.

Risk comes from the nature of certain kinds of businesses by the simple economics of the business, and from not knowing what you're doing. If you understand the economics and you know the people, then you're not taking much risk.

Munger: We'd argue that what's taught is at least 50% twaddle, but these people have high IQs. We recognized early on that very smart people do very dumb things, and we wanted to know why and who, so we could avoid them. [Laughter]

Buffett: We are willing to lose \$6 billion in one catastrophe, but our insurance business over time is not very risky. If you own a roulette wheel, you sometimes have to pay 35-to-1, but that's okay. We would love to own a lot of roulette wheels.

ADVICE ON LIFE AND OTHER

Current Role Models

I have a number of them – I'm not sure I want to name them. I've been very lucky – the ones I've had have never let me down. It would be a terrible experience and hard to get over. People have had it in marriage or business. The worst is with your parents. The reverse happened with me.

Choosing your heroes is very important. Associate well, marry up and hope you find someone who doesn't mind marrying down. It was a huge help to me – I can tell you that. [Laughter]

Munger: You're not restricted to living people when choosing your mentors. Some of the best people are dead. [Laughter]

Giving His Fortune Away

Buffett: I always felt I would compound money at a rate higher than average and it would have been foolish to give away a significant portion of my capital, which would have been spent within months. I thought my wife would be doing it [giving my fortune away], but that didn't work out.

When my wife and I had a baby, we hired an obstetrician – I didn't try to do it myself. When my tooth hurts, I don't turn to Charlie. Similarly, when it comes to giving money away sensibly, I let people who are smart, energetic and passionate do it. I want to give the claim checks to someone who can follow generally what I would do myself if I were to do it myself.

Munger: I think it's perfectly great for shareholders that you're letting someone else give away the money.

Buffett: For the smaller grant requests, I send them to my sister Doris, who likes to handle them.

As far as I'm concerned, I haven't given up anything. Someone who gives up an evening out or a lot of time or a trip to Disneyland because they donated to a church or whatever, they have given away something. I haven't changed my life. I can't eat any better or sleep any better, so I haven't really given up anything.

What are the best ways for a 10-year-old to earn money?

That was a subject I gave a lot of thought to when I was 10. You're probably a little young to deliver papers. I got half my capital from that – I liked it because I could do it by myself. You can do it when you're 12 or 13. I tried 20 different businesses by the time I got out of high school. The best was a pinball-machine business, but I wouldn't recommend it now.

I saw a study that correlated business success with a range of variables like grades, parents, whether one attended business school – and they found it correlated best with the age at which you first started in business. You see this in athletics and music as well.

Look for what people don't want to do for themselves. Ask around, see what other kids have done. A paper route is a good idea.

If some people in debt worked an extra one-and-a-half hours a day, they could pay off their debt.

Munger: When I was young, I read [The Richest Man in Babylon](#), which said to under-spend your income and invest the difference. Lo and behold, I did this and it worked. I got the idea to add a mental compound interest too, so I decided I would sell myself the best hour of the day to improving my own mind, and the world could buy the rest of the time. It sounds selfish, but it worked.

If you become very reliable and stay that way, it will be very hard to fail in doing anything you want.

Book recommendation: Supermoney

Jerry Goodman [who appears to also be called [George Goodman](#), who wrote under the name Adam Smith] wrote a book called [Supermoney](#). There is now a new and revised edition, and it is now outside in the bookstore.

Humor

I was worried about Charlie's hearing so I asked a doctor about it. He said to test Charlie's hearing by standing across the room and saying something. So I stood at the opposite side of the room and said, "I think we ought to buy GM at \$30." I got no reaction so I moved halfway across the room and said it again. Still no answer, so I went very close to him and said it and Charlie replied, "For the third time, yes!" [Laughter]

Would you rather have dinner with John Adams or Ben Franklin?

Munger: John and Abigail Adams were wonderful people.

Buffett: Did you know them personally, Charlie? [Laughter]

Munger: But if you wanted a lovely evening, you'd like Franklin. I think I have too much Adams and not enough Franklin.

Fixing the U.S. Healthcare System

Munger: It's too tough. We can't solve that one. We try to look for easy problems. We don't try tough things. Sometimes life hands you a very tough

problem you have to wrestle with – not financial problems for us, but personal ones.

If we were looking at a private-sector solution, we'd look for low distribution costs. You don't want a lot of revenue soaked up in frictional costs, but I don't know how to do that. If we're paying 15% of GDP [for healthcare], you'd think someone would figure it out. Maybe this will come up in the upcoming presidential campaign.

Ethanol

Munger: Even McCain has had a counter-revelation: he's decided ethanol is wonderful, now that he's recognized that that's how they think in Iowa. [Laughter]

I think the idea of running vehicles on corn is one of the dumbest ideas I've ever seen. Governments, under pressure, do crazy things, but this is among the craziest. Raise the cost of food so you can run these autos around? You use up just about as much hydrocarbons making ethanol as it produces, and its cost doesn't even factor in the permanent loss of topsoil. I love Nebraska to the core, but this was not my home state's finest moment.

Global Warming

Buffett: I believe the odds are good that global warming is serious. There's enough evidence that it would be foolish to say there's a 99% chance it *isn't* a problem. In this case, you have to build the ark before the rains come. If you have to make a mistake, err on the side of the planet. Build a margin of safety to take care of the only planet we have.

Gen Re writes way less business subject to the effects of global warming than does National Indemnity, which writes super-cat policies. We think much more about whether global warming will produce atmospheric changes that will change the frequency and intensity of major storms. We think the exposure goes up every year, even though we don't know exactly what goes on in the atmosphere.

The relationship is explosive – global warming could increase expected losses by two, three, four or five times. It's not something that keeps me up in terms of the financial prospects of Berkshire, but [it's worth thinking about].

Munger: Carbon dioxide is what plants eat. Generally speaking, it would be more comfortable if the world were a little warmer. It's not as if a vast flood of people are moving to South Dakota from southern California. [Laughter] It's not clear that it would be a disaster for all humans, but the dislocations would be hard.

Buffett: You don't think it would be a problem if the sea level were 15-20 feet higher?

Munger: With enough time, these things can be adjusted to. I don't think this is

likely to be an utter calamity for mankind. You'd have to be a pot-smoking journalism student to think so.

Buffett: We do know that in 2004 and 2005, hurricanes hit with a frequency and intensity that would not be expected looking at the past century. We were spared a far worse scenario by a couple of category 5 hurricanes that didn't hit the coastline.

I don't think Katrina is the worst that we'll see. I don't know all of the factors that go into hurricanes – there could be 50 variables, but all I know is that it's likely to get worse. And it would be crazy to write insurance at prices from a few years ago, so it's a factor for us.

Buffett's Support of Planned Parenthood

[The questioner attacked Buffett's charitable support of Planned Parenthood and was roundly booed.]

I think Planned Parenthood is a terrific organization. I really think it's too bad that for millennia women, not only in the U.S. but over the world, have involuntarily had forced upon them the bearing of babies, generally by governments run by men. [Applause]

I think it's an important issue that doesn't have a natural funding constituency – it's not like putting your name on a hospital. I think if we'd had a Supreme Court with nine women on it from the beginning, I don't think a question like yours would even be asked. I think it's wonderful that women can make reproductive choices. I hope you'll respect my opinion as I do yours. [More applause]

Protests by Salmon Fisherman of PacifiCorp's Dams on the Klamath River

[Two people asked essentially the same question; [here](#) is an article about the controversy]

Our position on it is quite simple: FERC [the Federal Energy Regulatory Commission] and other regulatory commissions have 27 different proposals in front of them from different interest groups. Some people have been hurt by what you describe, while others – several hundred thousand of them – like the cheap power. FERC will listen to the positions and make a decision. We are a public utility and we will do exactly what the people who regulate us say. It's entirely a question for FERC and the state commissions.

We will not make the determination in the end. It will be made by FERC – the same as with coal, gas or wind generation. Any time you get into public-utility plants, some people are unhappy with the decisions because no one wants a power plant in their yard. People often aren't happy with wind generation towers. But the world wants more electricity. So we will do exactly what FERC and the state commissions decide. As I said, there are 27 groups and they will hear the

arguments of all 27 and come up with the public policy decision. It takes a lot of time.

I'm in a peculiar position on this, because when we bought PacifiCorp, Walter Scott and I signed affidavits saying, "I agree that we will not exercise decisions except those ministerial in nature." We are recused from voting. This was part of the order that allowed MidAmerican to buy PacifiCorp. The acquisition went through in record time, by the way, because MidAmerican has such a great track record of being responsive to regulators.

Has there been any question that you haven't been able to get a comfortable answer to that also can't go in the "too difficult" pile?

Buffett: You may have just asked one.

Munger: If you have a child dying of a terrible disease, you can't just put it in the "too difficult" box. There are a lot of things you can't just put aside. But in investing, you can do this.

Buffett: With WMDs, you can't just put it in the "too hard" box. You have to wrestle with it because if you even reduce the probability a tiny bit, it is good. You hope you don't have too many like that.

Excerpt from 1995 Berkshire Hathaway Chairman's Letter

www.berkshirehathaway.com/letters/1995.html

GEICO Corporation

Right after yearend, we completed the purchase of 100% of GEICO, the seventh largest auto insurer in the United States, with about 3.7 million cars insured. I've had a 45-year association with GEICO, and though the story has been told before, it's worth a short recap here.

I attended Columbia University's business school in 1950-51, not because I cared about the degree it offered, but because I wanted to study under Ben Graham, then teaching there. The time I spent in Ben's classes was a personal high, and quickly induced me to learn all I could about my hero. I turned first to Who's Who in America, finding there, among other things, that Ben was Chairman of Government Employees Insurance Company, to me an unknown company in an unfamiliar industry.

A librarian next referred me to Best's Fire and Casualty insurance manual, where I learned that GEICO was based in Washington, DC. So on a Saturday in January, 1951, I took the train to Washington and headed for GEICO's downtown headquarters. To my dismay, the building was closed, but I pounded on the door until a custodian appeared. I asked this puzzled fellow if there was anyone in the office I could talk to, and he said he'd seen one man working on the sixth floor.

And thus I met Lorimer Davidson, Assistant to the President, who was later to become CEO. Though my only credentials were that I was a student of Graham's, "Davy" graciously spent four hours or so showering me with both kindness and instruction. No one has ever received a better half-day course in how the insurance industry functions nor in the factors that enable one company to excel over others. As Davy made clear, GEICO's method of selling – direct marketing – gave it an enormous cost advantage over competitors that sold through agents, a form of distribution so ingrained in the business of these insurers that it was impossible for them to give it up. After my session with Davy, I was more excited about GEICO than I have ever been about a stock.

When I finished at Columbia some months later and returned to Omaha to sell securities, I naturally focused almost exclusively on GEICO. My first sales call – on my Aunt Alice, who always supported me 100% – was successful. But I was then a skinny, unpolished 20-year-old who looked about 17, and my pitch usually failed. Undaunted, I wrote a short report late in 1951 about GEICO for "The Security I Like Best" column in The Commercial and Financial Chronicle, a leading financial publication of the time. More important, I bought stock for my own account.

You may think this odd, but I have kept copies of every tax return I filed, starting with the return for 1944. Checking back, I find that I purchased GEICO shares on

four occasions during 1951, the last purchase being made on September 26. This pattern of persistence suggests to me that my tendency toward self-intoxication was developed early. I probably came back on that September day from unsuccessfully trying to sell some prospect and decided – despite my already having more than 50% of my net worth in GEICO – to load up further. In any event, I accumulated 350 shares of GEICO during the year, at a cost of \$10,282. At yearend, this holding was worth \$13,125, more than 65% of my net worth.

You can see why GEICO was my first business love. Furthermore, just to complete this stroll down memory lane, I should add that I earned most of the funds I used to buy GEICO shares by delivering *The Washington Post*, the chief product of a company that much later made it possible for Berkshire to turn \$10 million into \$500 million.

Alas, I sold my entire GEICO position in 1952 for \$15,259, primarily to switch into Western Insurance Securities. This act of infidelity can partially be excused by the fact that Western was selling for slightly more than one times its current earnings, a p/e ratio that for some reason caught my eye. But in the next 20 years, the GEICO stock I sold grew in value to about \$1.3 million, which taught me a lesson about the inadvisability of selling a stake in an identifiably-wonderful company.

In the early 1970's, after Davy retired, the executives running GEICO made some serious errors in estimating their claims costs, a mistake that led the company to underprice its policies – and that almost caused it to go bankrupt. The company was saved only because Jack Byrne came in as CEO in 1976 and took drastic remedial measures.

Because I believed both in Jack and in GEICO's fundamental competitive strength, Berkshire purchased a large interest in the company during the second half of 1976, and also made smaller purchases later. By yearend 1980, we had put \$45.7 million into GEICO and owned 33.3% of its shares. During the next 15 years, we did not make further purchases. Our interest in the company, nonetheless, grew to about 50% because it was a big repurchaser of its own shares.

Then, in 1995, we agreed to pay \$2.3 billion for the half of the company we didn't own. That is a steep price. But it gives us full ownership of a growing enterprise whose business remains exceptional for precisely the same reasons that prevailed in 1951. In addition, GEICO has two extraordinary managers: Tony Nicely, who runs the insurance side of the operation, and Lou Simpson, who runs investments.

Tony, 52, has been with GEICO for 34 years. There's no one I would rather have managing GEICO's insurance operation. He has brains, energy, integrity and focus. If we're lucky, he'll stay another 34 years.

Lou runs investments just as ably. Between 1980 and 1995, the equities under Lou's management returned an average of 22.8% annually vs. 15.7% for the S&P. Lou takes the same conservative, concentrated approach to investments that we do

at Berkshire, and it is an enormous plus for us to have him on board. One point that goes beyond Lou's GEICO work: His presence on the scene assures us that Berkshire would have an extraordinary professional immediately available to handle its investments if something were to happen to Charlie and me.

GEICO, of course, must continue both to attract good policyholders and keep them happy. It must also reserve and price properly. But the ultimate key to the company's success is its rock-bottom operating costs, which virtually no competitor can match. In 1995, moreover, Tony and his management team pushed underwriting and loss adjustment expenses down further to 23.6% of premiums, nearly one percentage point below 1994's ratio. In business, I look for economic castles protected by unbreachable "moats." Thanks to Tony and his management team, GEICO's moat widened in 1995.

Finally, let me bring you up to date on Davy. He's now 93 and remains my friend and teacher. He continues to pay close attention to GEICO and has always been there when the company's CEOs – Jack Byrne, Bill Snyder and Tony – have needed him. Our acquisition of 100% of GEICO caused Davy to incur a large tax. Characteristically, he still warmly supported the transaction.

Davy has been one of my heroes for the 45 years I've known him, and he's never let me down. You should understand that Berkshire would not be where it is today if Davy had not been so generous with his time on a cold Saturday in 1951. I've often thanked him privately, but it is fitting that I use this report to thank him on behalf of Berkshire's shareholders.