Notes from the 2004 Berkshire Hathaway Annual Meeting

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Notes: This is not a transcript. Recording devices are not allowed at the meeting, so this is based on many hours of rapid typing, combined with my memory (egads!). 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 or edits, and all web link insertions are mine.

For more on this meeting, see my 5/3/04 column, Buffett's Wit and Wisdom. To read my columns and notes from previous Berkshire and Wesco meetings, click here. Links to all of my published columns are here.

COMMENTS ON BERKSHIRE HATHAWAY

Succession
[When asked why he doesn't ask Bill Gates to take over Berkshire when he's gone – there are always a few whacko questions – Buffett replied:]

Did Bill put you up to that [question]? [Laughter.]

We have four people today in the organization who can do my job – in some cases better than I can, in some ways not quite as well. That wasn't true 15 years ago.

We will have someone take over Berkshire who's been in the organization a long time. One reason is that we like the culture and want someone who knows the culture and how it works. Also, we've gotten to know them and observe them.

Maintaining the Culture
If I die first, all my stock goes to my wife. She might put it in the [Buffett] foundation then, or it'll go there when she dies. It has approximately 30% of the votes. By law, the foundation would have to get down to 20% within five years.

I think Berkshire has a far better chance than any major company of maintaining its culture [when Charlie and I are gone]. The people running it have grown up in the culture. My wife and son are there [on the board] as guardians of the culture.

A great example [of how this can work] is Wal-Mart when Sam Walton died. The Walton family has done a magnificent job of hiring successors to run the place and maintain the culture. The Waltons are there to step in if needed, but they don't run the business.

I think my family and Berkshire's managers will retain the culture.

Munger: If anyone would have a reason to worry, it would be me, but having known the Buffett family for decades, I say to you: "Don't worry about it. You should be so lucky."

[During the initial official-business part of the meeting, a shareholder asked Buffett why he had his son and wife on the board, rather than Berkshire operating managers, who (according to the shareholder) have more business experience. Buffett did not answer the question – perhaps because it was not the appropriate forum (the shareholder could have gotten in line and asked the question during the Q&A period) – but I think the answer is quite simple: Buffett is increasingly sensitive to making Berkshire a role model for good corporate governance (it always has been, but appearances are especially important these days). Hence, Berkshire added a number of world-class independent board members this year. However, Buffett also wants to be sure that Berkshire's unique culture is maintained forever, and he trusts his wife and son to ensure this more than anyone else.]

Compensation Systems at Berkshire

You could make a lot of money working for Berkshire, but it will relate to performance. No-one's going to make a lot of money for average performance.

We have some extraordinary management at MidAmerican [Energy Holdings]. In terms of compensation, there are two key individuals [David Sokol and Greg Abel]. For their compensation, I took a yellow pad, sketched out a proposal in two minutes, talked to Walter Scott (who's our partner in this business) and when he said it looked OK, talked to the managers. The only change was that we had more than 50% of the rewards going to the CEO, David Sokol, and he said to make it 50/50.

Charlie and I spend a couple of minutes [designing compensation plans]. It's not highly complex, but you have to understand the business. No one formula can work – that would be asinine. Take Chuck Huggins at See's – he's had the same plan for 30 years. For GEICO, there are two variables [that determine compensation] for Tony Nicely on down.

[From Buffett's 1996 annual letter, the two are: "Today, the bonuses received by dozens of top executives, starting with Tony, are based upon only two key variables: (1) growth in voluntary auto policies and (2) underwriting profitability on "seasoned" auto business (meaning policies that have been on the books for more than one year). In addition, we use the same yardsticks to

calculate the annual contribution to the company's profit-sharing plan. Everyone at GEICO knows what counts."]

We do not bring in compensation consultants and we don't have a human resources department, legal department, etc. That makes life way to complicated, and people get vested in going to conferences.

In some businesses, like network television, you'll earn a huge return on equity even if your nitwit nephew runs it (as long as you keep him out of the office). But other businesses are the opposite.

You should charge some cost of capital. Measure the key metrics, set a hurdle and only pay for adding value [above this hurdle], even if the returns appear low [but would have been a lot lower without the value the manager added]. If you had a group of network television stations, you would have 35% pretax margins if a chimp ran it, so you'd only pay for excess above this. It would be silly to have 10% or 15% hurdle, but a bad manager will try to get this.

In the end, if you have a great manager, you want to pay them very well.

Views on Berkshire Hathaway shareholders
[When asked why Berkshire Hathaway doesn't meet with analysts or large shareholders, Buffett replied:]

I have some problems with having meetings with some sub-groups of investors. If we had them, I'd want meetings with everyone. We try to convey a lot about our business in our annual report.

I don't think it fits our temperament at all. Many corporations spend a lot of time talking to analysts. One of our strengths is *not* doing this. It's very time-consuming and gives some shareholders an advantage. We're very egalitarian.

Munger: We like our current shareholders and don't want to entice anyone to become one. It would help current shareholders to hear our CEOs [of the Berkshire operating subsidiaries], but we promised them they could spend 100% of their time on their business. We place no impediments on them running their businesses. Many have expressed to me how happy they are that they don't have to spend 25% of time on activities they didn't like.

Buffett: We ask ourselves: "Are we telling you what we'd want to know if our positions were reversed?" We really try to put everything in our annual report that's germane to that. Anything that counts, in aggregate, we include.

The Washington Post has a shareholder day, which is very useful, because the annual meeting has turned into a farce, with so many people complaining about particular articles that were in the paper. But I really think that if we spend six hours here and spend time writing the annual report, we can convey the information we need to.

We’re not trying to appeal to people who care about next quarter or year. We want to appeal to people who view this as a lifetime investment. There are relatively few investors who think about buying and putting it away forever like a farm.

COMMENTS ON BERKSHIRE HATHAWAY'S INVESTMENTS & BUSINESSES

Junk bonds

When we were buying junk bonds, we focused on ones we could understand. They were yielding 30%, 35%, 40% to maturity. We thought of them like equities. Within 12 months, they went to yielding 6%. This is amazing, given that there were no major events. Prices do amazing things.

Super-Cat Insurance

[When asked how one might price super-cat insurance policies, Buffett replied:]

Try to be as realistic as you can on those numbers [the key variables] – err on being conservative – and then when you're through, make sure you have a margin of safety.

In pricing earthquake insurance, look at the number of major quakes in past century – there have been 26 – so we'd assume 30 or 32 going forward (not 50 or we'd never write any business). If we calculated the resulting price to be $1 million, then we'd price it at $1.2 million to build in a margin of safety.

Munger: Using the book Deep Simplicity [see link on page 33, below], you can predict how size is likely to be allocated. A standard power law will tell you how many earthquakes there will be of various sizes – many small ones, but big ones are less likely. So just do the math, apply the power law and calculate estimated damages.

Buffett: It's difficult if someone wants to protect against a 9.0 quake, which happens only once every 1,000 years. But in investing, if it's too hard, skip it.

MidAmerican Energy Holdings and Investment Opportunities in the Energy Sector

PUHCA [Public Utilities Holding Company Act] passed in 1935 as a justified reaction to some really wild antics in the 1920s in the public utility field, most dramatically in Sam Insull; there was pyramiding, capital structure... [For more on Insull, see this web page, which has the following sentence: "Another example comes from the breakup of Samuel Insull's empire, whose failure was a major source of the attack on holding companies…"] The act addressed a lot of wrong things, but it's long been outmoded. The SEC agrees and various energy bills included the repeal of it, but no energy bill passed last year.

PUHCA restricts what we do. But it's not clear that if it were repealed that it would create lots of opportunities for us, because other companies might be competing against us. So, it's not clear that Berkshire Hathaway would necessarily be worth a lot more money [if PUHCA were repealed]. But it would be logical to repeal it. There are plenty of regulations already.

It would be beneficial to have companies like Berkshire pouring money into this field. It will be repealed someday I think.

Munger: If there were a great opportunity in the energy field, we'd find a way to do it.

Buffett: That's right. There's been nothing we've wanted to do and couldn't. It isn't like we got one yard from the finish line [on a deal] and couldn't finish it. But the repeal of PUHCA may make life simpler on a large transaction.

PetroChina

PetroChina is not opaque. It's very similar to big oil companies elsewhere in the world. It's the 4th most profitable oil company in the world – it produces as much crude as Exxon. It's not complicated – it's a big integrated oil company, so it's fairly easy to get your mind around the economics of the business.

The annual report will tell you more about the business than [the annual reports of] other oil giants. They tell you they'll pay out 45% of their earnings, barring the unexpected. I like knowing that that cash will come to Berkshire.

It was bought because it was very, very cheap by any metric – *far* cheaper than Exxon, BP, Shell... You could say it should be cheaper, given that it's 90% owned by the government of China, which is a factor, yes, but not so big for me. If you read the annual report of PetroChina, you'll have as good an understanding of the company as reading the annual report any other oil company. Then, you can think about risks such as a disruption of US-China relations.

Munger: I think if it's cheap enough, you can afford more country risk or regulatory risk. It's not complicated.

Buffett: There's Yukos, the big oil company in Russia. In evaluating country risk, you can reach your own judgments. In our view, PetroChina had less risk.

[Later in the meeting, Buffett and Munger returned to the discussion of this company:]

Buffett: You don't need any blinding insights to invest in PetroChina. They're producing 2.5% of the world's oil, it's priced in US dollars, they control a significant part of the refining in China, and they pay out 45% of their earnings in dividends. If you're buying something like that at 1/3 the valuation of comparable companies, it's not hard. You just have to do the work.

Munger: But when you were buying, no-one else was. It required uncommon sense.

National Indemnity and Incentives in the Insurance Business

We are very big in insurance and having the wrong incentives in place could be very harmful.

[Buffett had prepared slides and had them put up on the screens in the convention center. Slide 1 showed Berkshire Hathaway's balance sheet shortly before it bought National Indemnity.]

For 15 minutes each year, Jack Greenwald [the owner of National Indemnity] would get frustrated with something and want to sell his company. I told Charlie that the next time he was in heat, bring him to me. So, we bought it in '67 for $7 million.

[Slide 2 showed premium volume for National Indemnity from 1980 through 2003. It was $80 million in 1980, rose to $366 million in 1986, then declined nearly every year down to $54 million in 1999, and then spiked up to $595 million in 2003. Buffett highlighted the decline from 1986 to 1999 and asked:]

How many public companies in America would see premiums go down every year for such an extended period?

[Slide 3 showed the number of employees at National Indemnity from 1980-2003. The number rose from 1980-86 and then declined from 1986-99, but much more slowly than premiums declined. Buffett noted:]

We never fired anyone – the decline in headcount was solely due to retirements. The key is you can't fire people if they don't write business, or they'll write business. You must be able to tell them that if they write no business, their job is *not* in jeopardy.

[Slide 4 showed National Indemnity's expense ratio from 1980-2003, which was as low as 25.9% in a peak year, and as high as 41% in the worst year, 1999. Buffett noted that:]

Some companies would feel that this is unacceptable. [We don't.] We can take an expense ratio that's out of line, but can't take writing bad business.

[Slide 5 showed the combined ratio at National Indemnity from 1980-2003. The combined ratio exceed 100 during a few bad years for the industry in the early 1980s, which is what led to the hard market that peaked in 1986, but National Indemnity's combined ratio has been below 100 – e.g., the business has been profitable – in every year for the past 20. Buffett pointed out:]

In 1986, our combined ratio was only 69.3 because we did the most volume ever that year, up to that point [the company has done more volume in the past few years]. We coined money when we wrote a lot of business, and made a little when we didn't. We're the only company like this. We'll have a high expense ratio when business is slow.

National Indemnity was a no-name company when we bought it, and has no copyrights, patents, etc. to distinguish it, but they have a record like no-one else because they had discipline.

You can't run an auto or steel company this way, but it's the best way to run an insurance company.

Munger: Nobody else does it, but to me it's obviously the only way to go. A lot about Berkshire is like this. Being controlling owners is key – it would be hard for a committee to make these kinds of decisions.

HomeServices of America

HomeServices will grow. It owns 15-16 local real estate firms, which retain all of their local identities – akin to the whole Berkshire model. Managers operate them as if they owned them

themselves. We have no national identity, unlike Cendant, which operates under a few big names.

There's no question that we'll buy a few – or a lot – of [real estate brokerage] companies over the next 10 years. It's a great company with great management. Last year, we participated in $50 billion of transactions – but this was only a small percentage of the national total. We're big in California, Minnesota and Nebraska.

It's a good business, but very cyclical. It's very good now. We'll go through a bad period, but we'll keep buying. I don't know how big it will become, but it's conceivable that as we grow, we'll add things like buying furniture. When people buy a new house, they need a lot of things.

[In response to another question about whether the internet will threaten the commission structure of real estate brokers like HomeServices, Buffett replied:]

I think commissions in HomeServices are sustainable. Barry Diller is interested in the space via Lending Tree, and the internet is a threat to any business, including real estate brokerage. But when I think about the process of owning a home, the for-sale-by-owner (FSBO) was with us 50 years ago and it is now [but it hasn't affected commissions]. My guess is that 30 years from now, a very significant percentage of home sales will be done through the brokerage system like today's, though there are people trying to change it.

Munger [speaking to Buffett]: You tried to change it dramatically in Omaha, and you fell on your ass. [Chuckling.] You tried to take home listing business from the Omaha World Herald with your little paper and failed.

GEICO, the History of the Direct Model, and the Importance of Being the Low-Cost Producer

The idea of direct marketing in auto insurance at GEICO came from Leo Goodwin and his wife. They came from USAA, which was established because US military personnel moved around a lot and had trouble getting insurance. Leo took this idea and broadened it beyond military officers. It's a better system.

Going back 100 years, auto insurance was sold by casualty companies via a system of agents that charged large commissions. It was a cartel. State Farm was formed in the 1920s and had the idea of a captive agency force, which brought down costs. It became the largest auto insurer, and Allstate because #2 following the same model. This was a better system.

Leo bypassed the agents and brought down costs even further.

Every American family has to buy auto insurance. It's not a luxury item, so cost is key and the low cost is going to win. The direct sellers, GEICO and Progressive, will slug it out and will win. GEICO has a tough competitor in Progressive – they've seen how we've done it [the direct model] and are moving to it.

Dell is very efficient. I'd hate to compete with them. If they turn out a decent competitive product at a good price, that system will win.

Charlie is on the board of Costco. Costco and Wal-Mart have figured out how to do this [be ultra-low-cost] and they're winning.

It's always a good idea to go with the low-cost producer over time. Being the low-cost producer of something that people need is a good business.

Wells Fargo and Its Derivatives Risk
[A shareholder asked why Buffett felt comfortable owning Wells Fargo stock, and even buying more, given its exposure to derivatives. Buffett replied:]

I don't have Wells Fargo's annual report here, but I'd bet that J.P. Morgan Chase is far larger [in terms of exposure to derivatives]. I don't think of them [Wells Fargo] as being a big player in the derivatives game.

There is no perfect measure of the size of a derivative position. The numbers sound large that are thrown around, but you can talk about a $1 billion notional exposure in one derivative and have less risk than a $50 million derivative of another type. I don't think Wells Fargo is a really big derivatives player.

Wells Fargo is an exceptional bank. We disagree with management violently on expensing stock options, so I voted our stock to expense options. But even though I disagree on this accounting point, management has a terrific record. Dick [Kovacevich, Well Fargo's Chairman and CEO] is a great guy and I'd rank him way up there in terms of bank managers.

Criticism of MidAmerican's Environmental Record
[A shareholder asked about an article he read – perhaps this one – that was critical of David Sokol's support for President Bush because, the article claimed, MidAmerican was seeking concessions from the government on environmental matters. Buffett asked Sokol to take the microphone and Sokol said (my notes are weak here):]

The article criticized me for being a Ranger [a category of large donors who produce $200,000 or more] for President Bush. The article implied that I was trying to influence the Bush Administration so that MidAmerican could benefit from weaker environmental standards. In fact, MidAmerican has a great environmental record. Also, my being a Ranger was certainly not an attempt to influence regulation/legislation – and incidentally, I'm no longer a Ranger.

Silver Position
I have no comment on whether we've added to, held, reduced or completely sold our silver position. But I would disagree with you very much that the gold or silver market is rigged. Many writers have conspiracy theories. The answer is that there is plenty of silver above ground and I'm not sure of supply and demand recently, but there's nothing flawed about the market of any commodity I can think of.

Munger: You're asking for the opinion of people who haven't particularly distinguished themselves in this arena.

Foreign Currencies

[Buffett was not asked about his foreign currency holdings at the annual meeting, but at another venue he, according to one news story I read, "said he has increased his bet against the U.S. dollar in the past several months on concern that the U.S. trade deficit will weaken the currency over time. Buffett told reporters…that he has boosted his foreign currency holdings by 'more than a little bit.'"]

OTHER BERKSHIRE HATHAWAY COMMENTS

Thinking on Investing Berkshire's Cash
[When asked about the relative attractiveness of bonds, arbitrage, etc., Buffett replied:]

Charlie and I are competent to make judgments on certain things, and not other things. We try to focus on what we can understand, which is a reasonable amount.

In the summer to mid-fall of 2002, when junk bonds became very attractive, we bought a lot. But we did not make a big decision to buy junk bonds – it's just that a lot of them got really cheap.

We have an open mind – whatever we see on a given day that overcomes our resistance to take risk, we'll do. Charlie and I do not have a checklist to prioritize categories. I hope he gets a good idea, he hopes I have one and if we find one, then we move, hopefully in a big way. It has to be big.

We're recently made big investments in currencies and viatical settlements. We don't do arbitrage any more because we're too big.

Munger: We have a lot of cash because we don't like any of those fields at the moment. Trying to prioritize among things we're unlikely to do is pretty fruitless.

Investment Mistakes
The main mistakes we've made – some of them big time – are: 1) Ones when we didn't invest at all, even when we understood it was cheap; and 2) Starting in on an investment and not maximizing it.

Charlie is a big fan of doing things on a big scale. But when I bought something at X and it went up to X and 1/8th, I sometimes stopped buying, perhaps hoping it would come back down. We've missed billions when I've gotten anchored.

Munger: Do you have anything worse to confess than Wal-Mart?

Buffett: I cost us about $10 billion. I set out to buy 100 million sharers, pre-split, at $23. We bought a little and it moved up a bit and I stopped buying. Perhaps I thought it might come back a bit – who knows? That thumb-sucking, the reluctance to pay a little more, cost us a lot. There are other examples.

On the other hand, it doesn't bother us. If every shot you hit in golf was a hole-in-one, you'd lose interest. You gotta hit a few in the woods.

We probably won't make the kind of mistake that costs us a lot – though we did with Dexter Shoes. We're more likely to make mistakes of omission, not commission, in the future.

Munger: Since mistakes of omission don't appear in the financial statements, most people don't pay attention to them. We rub our noses in mistakes of omission – as we just did.

Berkshire Running a Mutual Fund?
[Responding to a shareholder's suggestion that they get into the money management business, Buffett replied:]

There would be too many conflicts. We're managing too much money as it is and we can't wear two hats. I certainly wouldn't want to start a fund management company and then pro-rate purchases. I've been pitched many times [to start a fund company] and we could certainly sell it, but once we did so I don't know what we'd do with it. Do you, Charlie?

Munger: No. That's why we don't do it. But that doesn't seem to bother other people.

Competition to Buy Companies
You are absolutely correct that the private equity funds are a form of competition for Berkshire. Stocks sometimes trade well below intrinsic value, but businesses are sold in a negotiated transaction, so pricing doesn't get as extreme. But our strong preference is to buy entire businesses at a fair price rather than stocks, even if stocks [can be acquired] a bit cheaper.

If someone wants what we are offering, we are pretty much one-of-a-kind. People can sell their company to us, yet continue to run it as they please as long as they want. So, if someone needs liquidity for tax or inheritance or other reasons, but doesn't want to auction their business off like a piece of meat, they can come to us and they know they'll get the response they want. We don't get super bargains this way, but it allows us to put money to work at a sensible price.

Acquisitions don't come along every day.

If I owned a business that my father had started and wanted to monetize it, I would sell to Berkshire because I wouldn't want to split it up to auction it off, just as it would be silly to auction your daughter off to the man who bids the most.

There is no-one else who can make the promises we can make [not to ever sell the acquired company]. Most big companies can't do that because what if the board decides it wants a pure play? I tell sellers that I'm the only one who can double cross you – nobody else can. We don't have consultants or Wall Street advisors.

But, yes, we do have a lot of competition.

Munger: We've had private equity competitors for a long time, but one way or another we've managed to buy quite a few things.

Splitting the Stock
We have the best investors and the lowest turnover of any major company. Why? It's a self-selection process. People who say they're not interested in a stock that trades for thousands of

dollars per share, simply for this reason, are probably not as intelligent or as in-sync as this group [referring to Berkshire's current shareholders]. It's a sign, a symptom.

By not splitting, we've helped attract the best shareholders – people who don't care if the stock is at $90,000 or $9.

Munger: I think the notion that liquidity of tradable common stock is a great contributor to capitalism is mostly twaddle. The liquidity gives us these crazy booms, so it has as many problems as virtues.

After the South Sea bubble, England banned tradable stocks and England did fine during this period. If you think liquidity is a great contributor to civilization, then you probably think all real estate in America, which is mostly illiquid, is a problem.

Buffett: Berkshire trades $50 million per day, so very few people will have problem selling.

Munger: But were trying to create more people who have the problem of owning stock worth so much that liquidity is an issue.

Buying the Stocks of Businesses That Make Unhealthy Products
I've been drinking five cokes a day for years and I feel terrific.

We passed one time on the chance to buy a terrific business, [even] after we [spent the time and] met management. They were fine people, but we didn't want to be in the business. But we'd buy stock in the business.

[I initially thought Buffett might be referring to UST, but a friend emailed me the following: "The company was Conwood in the late 1980s. Conwood was shopping itself to avoid a raider that it didn't want to get involved with. It eventually went private with the Pritzker family of Chicago. Buffett discussed this at a meeting some years back. I think he said he passed on owning the whole thing because of the even slight risk that he'd have to spend any of his time with lawyers suing the company." Another friend added, "Interestingly, Conwood has been gaining market share at UST's expense ever since then, and also collected a huge antitrust judgment against UST a year or two ago. So as usual, WEB and CM were right when they identified it as a terrific business many years ago. But I have no regrets that they passed on the deal. Apart from the moral grounds, we don't need the legal risk."]

I don't have any problem with buying stock or bonds of companies that engage in activities that I wouldn't endorse myself, but I'd have a problem with owning outright and directing the activities myself.

Every retailer sells cigarettes, but it doesn't bother me to own the retailer.

Munger: But you wouldn't own the company that made the tobacco or the advertisements.

Buffett: Yes. I can't tell you why I draw the line there, but I do. One time, I owned the bonds of RJR, and I'd still do it, but I would not buy the company. We walked [away from] one [situation like this] – we were thinking about it…

Munger: We didn't think very long. We don't claim to have perfect morals, but at least we have a huge area of things that, while legal, are beneath us. We won't do them. Currently, there's a culture in America that says that anything that won't send you to prison is OK.

Buffett: Eating hamburgers or drinking Coke – that's a choice. If one lives to 75 eating what they want or 85 eating carrots and broccoli – who's lived a better life? I know where I come out on that. [Laughter.]

I've never been near a Whole Foods Market.

Munger: My idea of a good place to shop is Costco – it has these heavily marbled fillet steaks. The idea of eating some wheat thing and washing it down with carrot juice has never appealed to me.

Buffett: Charlie and I never disagree on where to eat. [Laughter.]

Buffett's Salary
[A shareholder pointed out that Buffett's salary is only about 10 cents/year/A share and suggested shareholders would happily pay him 25 cents/share/year. Buffett replied:]

I would pay to have this job. It doesn't get any better than this. I'm getting SS now. My family would go crazy if I were getting any more money.

Google's Owner's Manual Modeled After Berkshire's
I'm pleased that the fellows at Google were, they say, inspired by the Berkshire Owner's Manual, and that they think it's good for companies to communicate with shareholders. If you read it [the Google Owner's Manual], you know what they're like.

It's like writing a letter to your partner in a business, in which you'd say, "I'd like you to join me as a partner, I'd like you to invest your money, so here's the information I want you to have and how I will treat you..."

I like their prose, though that doesn't mean I agree with every idea. I hope more companies sign on for this.

Munger: Most of the world doesn't in any way imitate Berkshire Hathaway. 19,500 Berkshire shareholders came [the announced attendance at this year's annual meeting], but we're the quirky few.

The Google guys are among the smartest in the country – it's always nice to be imitated by smart people.

Buffett: We think they're a lot smarter this week than last [because they imitated us]. [Laughter.]

HOW TO BECOME A BETTER INVESTOR

General
If we were to do it over again, we'd do it pretty much the same way. The world hasn't changed that much. We'd read everything in sight about businesses and industries we think we'd understand. And, working with far less capital, our investment universe would be far broader than it is currently.

There's nothing different, in my view, about analyzing securities today vs. 50 years ago.

Ongoing Learning
I haven't been continually learning the basic principles [of sound investing], which are still Ben Graham's. They were affected in a significant way by Charlie and Phil Fisher in terms of looking at better businesses. And I've learned more about how businesses operate over time.

You need an intellectual framework, which you can get mostly from The Intelligent Investor. Then, think about businesses you can get your mind around if you really work at it. Then, you will do well if you have the right temperament.

Munger: I've watched Warren for decades. Warren has learned *a lot*. He can pooh pooh investing in PetroChina, but he's learned, which has allowed him to [expand his circle of competence so he could invest in something like PetroChina].

If you don't keep learning, other people will pass you by.

Temperament alone won't do it – you need a lot of curiosity for a long, long time.

Filter Out the Noise
Munger: Part of [having uncommon sense] is being about to tune out folly, as opposed to recognizing wisdom. If you bat away many things, you don't clutter yourself.

Buffett: People get frustrated because they start to pitch something to us and when they get halfway through the first sentence, we say we're not interested. We don't waste a lot of time on bad ideas.

When humans compete against computers in chess, how can human compete? The human eliminates 99% of possibilities without even thinking about it – they get right down to few possibilities that have any chance of success. They get rid of the nonsense.

When people call you with bad idea, don't be polite and waste 10 minutes.

Thinking About Risk
We think the best way to minimize risk is to *think*. Our default is [to have our capital] in short-term instruments and only do something when it makes sense.

The Importance of the Right Temperament
Munger: We read a lot. I don't know anyone who's wise who doesn't read a lot. But that's not enough: You have to have a temperament to grab ideas and do sensible things. Most people don't grab the right ideas or don't know what to do with them.

Buffett: The key is to have a "money mind," which is not IQ, and then you have to have the right temperament. If you can't control yourself, you're going to have disasters. Charlie and I have seen it. The whole world in the late 1990s went a little mad in terms of investments. How could that happen? Don't people learn? What we learn from history is that people don't learn from history.

Diversification
You'll occasionally see something that so obvious that you'll load up on it, like junk bonds in 2002 or Berkshire Hathaway many years ago. If you think you'll see an opportunity every week, you're going to lose a lot of money.

Munger: The idea of excessive diversification is madness.

Asset Allocation
We don't hold any committee meetings. The business of saying you should have 50% in stocks, 30% in bonds…it's nonsense.

The idea of recommending that assets should be split 60/40 [between stocks and bonds], and then have a big announcement that you're moving to 65/35 is pure nonsense. It just doesn't make any sense.

Valuation Matters
If you pay way too much for a business, you'll get a poor return on what you paid, even if the return on tangible equity is very good.

Avoid Leverage
The most dramatic way we protect ourselves is we don't use leverage. We believe almost anything can happen in financial markets. The only way smart people can get clobbered is [if they use] leverage. If you can hold them [the positions you own during a crisis], then you're OK. But even smart people can get clobbered with leverage – it's the one thing that can prevent you from playing out your hand.

Weathering Financial Cataclysms
Absent leverage or just going crazy on valuation, the financial cataclysms won't do you in. And if you have any more money, you buy.

Berkshire is in an extraordinary position to weather any financial cataclysm. While we don't go around like an undertaker, hoping for a plague, we would benefit [in such a situation] and have done so in the past. We've never gotten hurt in the past 30-40 years by what's going on in the world around us.

Spotting Crooked Managements
Munger: Bernie Ebbers and Ken Lay were caricatures – they were easy to spot. They were almost psychopaths. But it's much harder to spot problems at companies like Royal Dutch [Shell].

Buffett: [Throwing up his hands] Charlie and I would not have spotted the problems at Royal Dutch.

Munger: But we don't learn because I'd still expect that Exxon's figures are fair.

Buffett: In the late 1990s, one business leader after another was cutting corners. They sink faster to a lower prevailing morality than rise to a higher prevailing morality, but they still generally follow the crowd.

Munger: I want to make an apology. Last night, referring to some of our modern business tycoons – specifically, Armand Hammer – I said that when they're talking, they're lying, and when they're quiet, they're stealing. This wasn't my witticism; it was used [long ago] to describe the robber barons.

Forecasts
Munger: People have always had this craving to have someone tell them the future. Long ago, kings would hire people to read sheep guts. There's always been a market for people who pretend to know the future. Listening to today's forecasters is just as crazy as when the king hired the guy to look at the sheep guts. It happens over and over and over.

Thinking About Growth Rates When Estimating Valuation
When the [long-term] growth rate is higher than the discount rate, then [mathematically] the value is infinity. This is the St. Petersburg Paradox, written about by Durand 30 years ago. [Click here for a copy of the original 1957 article. For more on this topic, I recommend Integrating the Outliers: Two Lessons from the St. Petersburg Paradox, by CSFB's (now Legg Mason's) Michael Mauboussin.]

Some managements think this [that the value of their company is infinite]. It gets very dangerous to assume high growth rates to infinity – that's where people get into a lot of trouble. The idea of projecting extremely high growth rates for a long period of time has cost investors an awful lot of money. Go look at top companies 50 years ago: how many have grown at 10% for a long time? And [those that have grown] 15% is very rarified.

Charlie and I are rarely willing to project high growth rates. Maybe we're wrong sometimes and that costs us, but we like to be conservative.

Munger: If your growth rate is so high that you conclude the business has an infinite valuation, you have to use more realistic numbers. What else could anyone do?

Avoid Bad Businesses

In the textile industry, we always had new machinery that held the promise of increasing our profit, but it never did because everyone else bought the same machinery. It was sort of like being in a crowd, and everyone stands on tip-toes – your view doesn't improve, but your legs hurt.

Thinking About Regulatory Risk

In some businesses, regulatory changes have a big impact, others none. We just try to think intelligently about any business that we're in. What regulatory changes might there be? What might the impact be? If we're in furniture retailing, we're not going to think about it. It's up to Charlie and me to think about this and weigh it in our evaluation of a company.

Munger: In our early days, we tended to overestimate the difficulties of regulation. We refrained by buying the stocks of television stations because we thought it was peculiar that someone could ask to have the government pull your license any year – and the government could do it.

Buffett: Tom Murphy [the former head of Capital Cities and Cap Cities/ABC; click here to read a 2000 interview with him] was way ahead of us on this one.

Index Funds

[When asked whether one should buy Berkshire, invest in an index fund, or hire a broker, Buffett replied:]

We never recommend buying or selling Berkshire. Among the various propositions offered to you, if you invested in a very low cost index fund – where you don't put the money in at one time, but average in over 10 years –you'll do better than 90% of people who start investing at the same time.

Munger: It's hard to sit here at this annual meeting, surrounded by smart, honorable stock brokers who do well for their clients, and criticize them. But stock brokers, in toto, will do so poorly that the index fund will do better.

BUSINESS AND INVESTING TOPICS

Outlook for the Market
[In response to a shareholder expressing the many reasons why he is concerned about the future outlook for the economy and the market, Buffett replied:]

I would say that at any given point in history, including when stocks were the cheapest, you could have found an equally impressive list of negatives. In '74, you could have written down all kinds of things that would show the future would be terrible.

We don't pay any attention to this kind of thing. Our underlying premise is that this country will do very well and that businesses will do very well. We used nuclear bombs, endured the cold war, etc., but over time the opportunities have won out over the problems. I expect this will continue, barring use [against us of] weapons of mass destruction – it would be hard for businesses to win out over this.

Going back to '59, I can't think of any discussions Charlie and I have had in which we've passed on something because of a view on macro conditions. It won't be the economy that will do in investors; it will be investors themselves. If you'd just owned stocks over time, you'd do fine. We're unaffected by the variables that you mentioned. Show us a good business tomorrow and we'll jump.

Munger: We wouldn't be surprised if professionally managed money in the US will have unimpressive returns relative to the high returns we had until three years ago.

Buffett: Our expectations were more modest than most three years ago [see Buffett's *Fortune* article, Mr. Buffett on the Stock Market, 11/99]. We didn't project the end of the world, but said anyone who thought they could sit at home and day trade to double digit returns was living in a fool's paradise. It's hard to understand how people could believe such things. To some extent, they're sold these beliefs.

Impact of Inflation
The best thing to combat the threat of inflation is to have a lot of earnings power of your own. If you're the only surgeon in town, you'll be OK [because you can simply raise your prices to keep up with inflation and people will pay it]. Charlie and I think it's best to own fine businesses that can price in inflationary terms and don't require big capital investments. See's Candies can handle an inflationary world and maintain value.

Unfortunately, most businesses will not come out well in real terms. Earnings might be up, but the business will be compelled to invest more and more dollars into the business to stay in place. The worst businesses compel you to put more and more in, without any rise in profits.

TIPS [Treasury Inflation Protected Securities] are not a bad investment for people worried about inflation heating up, which we're seeing signs of.

Munger: Most people will see declining returns [due to inflation]. One of the great defenses if you're worried about inflation is not to have a lot of silly needs in your life – if you don't need a lot of material goods.

Buffett: Charlie, we're selling a lot of material goods in the other room, so keep quiet. [Laughter.]

The Mutual Fund Scandal

Munger: The business of selecting investment managers was recently shown to be even harder by the revelation that a significant fraction of mutual fund managers took bribes to betray their own shareholders.

It was as if a man came up and said, "Why don't we kill your mother and we'll split the insurance money?" And many people said, "Why, yes, I'd like some of that insurance money."

Buffett: And they were already rich.

Munger: And many of them think what happened to them was unjust.

Buffett: Many people *had* to know what was going on. Many people at the big funds, even if they were not doing it themselves, had to know. The Investment Company Institute was patting itself on the back and getting cozy with legislators, but nothing was done until a whistleblower went to Spitzer and he publicized it.

Hundreds of people knew and it went on for a long time, but nobody did anything.

Compensation Systems

[Our approach to compensation] is wildly different from the approach of most companies, which go through elaborate procedures. The typical corporation has a compensation committee, and believe me, they don't ask Dobermans to be on it; rather, they want Chihuahuas who've been sedated.

I've been on 19 boards and only been asked to be on one compensation committee – and they regretted it. [In that case, because I opposed the compensation plan,] I was outvoted – by two smart, honorable people, by the way.

I've never seen a compensation consultant say: "This bozo you've got [the CEO] is only worth half what you're paying him."

It's an unequal negotiation [between the board and the CEO]. The CEO really cares, but to the board, it's play money. It's hard for board members – they just get handed a piece of paper showing what the top quartile of comparable CEOs get paid, so there's a ratcheting effect. In this kind of system, things will quickly get out of whack. There's some change now, but it's not being led by CEOs.

Munger: I'd rather throw a viper down my shirt front than hire a compensation consultant.

Irrational Markets
In insurance, we think a lot more about low-probability events than most people. We think more about big events in the financial arena than the natural arena. Financial markets have vulnerabilities that we try to think of and build in ways to protect us against them – and even some capabilities where we might profit in a huge way.

Munger: The temporary collapse in junk bonds, where they got to 35-40% yields, was just a strange thing. There was absolute chaos at the bottom tick. Apply this behavior to stocks – it's not hard to imagine a big crunch coming along.

Buffett: It's a fascinating thing to me: in 2002, there were tens of thousands of smart people, money was available, everyone had the desire to make money, yet look at what happened [to the prices of junk bonds]. Extraordinary things happened. Can these be the same people [buying such bonds yielding 6% today] who let them sink to such levels?

Wall Street is awash in money and talent, but you get these absolutely extraordinary swings. It doesn't happen with apartments and other types of assets.

At the minimum, you want to protect yourself from this type of insanity from wiping you out – and better yet, make a profit from it.

Risk of Derivatives
We don't think that in any year the chance is very high that derivatives will lead to or greatly accentuate a financial trauma, but we think it's there.

It's fascinating to look at a company like Freddie Mac: an institution that dozens of financial analysts were looking at; that had an oversight office; that was created by Congress with committees to oversee it; that had two smart, exceptional board members, Marty Leibowitz and Henry Kaufman; and that had auditors present – yet Freddie misstated earnings by $6 *billion* in a short time. That's big money. And a large part of it was facilitated by derivatives. You can go back and read the footnotes, listen to the conference calls, etc. and you wouldn't have known. In the end, it was $6 billion, but it could have been $12 billion if they'd wanted.

Derivatives can lead to a lot of mischief. When you have a complicated derivative transaction, and a trader with investment house A on one side and investment house B on the other side, and on the day the deal is done, both record a profit, this can lead to mischief – and the scale is getting bigger every day.

I know the managements of many large financial institutions and they don't have their minds around this. We tried at Gen Re [where we had a small derivative book] and couldn't.

Whatever problems there were at Salomon [during its crisis years ago], they're far, far worse now [systemwide].

In 1991, if the government hadn't reversed himself [in its plans to take actions that would have put Salomon out of business], we were preparing documents [to file for bankruptcy. Had this happened,] We had $1.2 trillion [notional value] of derivative contracts that others were counting on, that would have gone bad. All sorts of securities transactions wouldn't have settled, accounts in Japan and the UK would have been affected, etc. For instance, Salomon had a relationship with a bank in Germany which took large deposits in Germany and lent the money to Salomon. All kinds of things would have come out. You don't need to put these strains on a system that's already highly leveraged.

When you get huge amounts of transactions, which not many people understand, you create a huge problem that may be triggered by an exogenous event.

We use derivatives – we get them collateralized – and we've made money on them. But I predict that sometime in the next 10 years, we will have a big problem caused by or exaggerated by derivatives.

Munger: People don't think about the consequences of the consequences. People start by trying to hedge against interest rate changes, which is very difficult and complicated. Then, the hedges made the results [reported profits] lumpy. So then they use new derivatives to smooth this. Well, now you've morphed into lying. This turns into a Mad Hatter's Party. This happens to vast, sophisticated corporations.

Somebody has to have to step in and say, "We're not going to do it -- it's just too hard."

It was bonkers and the accountants sold out.

Buffett: If you want to have a little fun, go to the annual meeting of a big financial company and ask about the details of a complex transaction. They won't know – but you can be sure the trader who did it will be well paid for it.

Any time you have situation where smart people can make money by taking risk, you'll get it.

Derivatives were supposed to spread risk, and some make that argument today. This may be true much of the time, but what about when risk becomes highly concentrated in a few institutions? Coke is better able to take currency risk than most trading desks. Overall, there's much more risk in the system because of derivatives.

Derivative Risk vs. Super Cat Reinsurance Risk

[In response to a shareholder who compared super cat reinsurance risk to derivative risk, Buffett responded:]

The derivative contracts that Gen Re wrote are not similar to the super cat insurance we're writing. We're reinsuring personal or business risks others don't want to or are unable to bear. In our view, it made no sense to be in the derivatives business.

Munger: They're radically different. Derivatives are full of clauses that say if one party's credit gets downgraded, then they have to put up collateral. It's like margin – you can go broke. In attempting to protect themselves, they've introduced instability. Nobody seems to have recognition of what a disaster of a system they've created. It's a demented system.

Buffett: Had Berkshire not bought Gen Re, which was rated AAA, it could have run into terrible financial difficulty post-9/11, especially if they'd recognized their actual liabilities. They would have been downgraded, which could have triggered things in derivative activities which would have triggered coming up with loads of cash.

The system wasn't built to last. Many CEOs at major financial institutions don't really comprehend that. When you get margin calls for huge amounts of money, it only has to be one day when you can't meet it [and you can be forced to file for bankruptcy]. In 1987, there was a large wire transfer that was late arriving at a Chicago brokerage house, and it came close to unraveling the system (the money finally showed up).

Corporate Governance
[A shareholder asked what Buffett thought of the Calpers/ISS proposal that he should not be on Coke's audit committee. (From a Forbes article: "The California Public Employees Retirement System, or Calpers, and investor advisory group Institutional Shareholder Services argued that votes for Buffett for the Coke board should be withheld because Berkshire subsidiaries, such as ice cream chain Dairy Queen and food distributor McLane Co., do business with the world's largest soft drink maker… In defending the decision last month, an ISS spokesman said the group didn't want Buffett off the board entirely, just off of the audit committee, which should operate with zero tolerance for any conflicts. The spokesman said they don't make exceptions for anyone, even Buffett.") Buffett replied:]

I would say that whoever suggested that should do 500 sit-ups [this was a reference to a funny skit in the movie shown before the meeting, in which Arnold Schwarzenegger punishes Buffett for taking about raising taxes in California by making him to do 500 sit-ups].

Actually, Charlie and I have encouraged the idea that shareholders should behave like owners, not sheep – where, in too many cases, they've been shorn. Big institutional shareholders have too long sat on the sidelines when they should have been active. [Now that they're finally waking up,] the question is: Can they behave like intelligent owners? In last year or two, as they've woken up, they've searched for checklists, but frankly, a checklist is no substitute for thinking. Bertrand Russell once said: "Most men would rather die than think. Many do."

A board's real job is to find the right CEO and prevent him or her from overreaching. Not much else matters.

I think it's absolutely silly, if Berkshire Hathaway owns 200 million shares of Coke worth $10 billion, to think that because Berkshire Hathaway sells a few hours of flight training to Coke, that I'm conflicted. It's almost absurd that people don't understand proportionality at all.

I receive $100,000 per year [to sit on Coke's board]. This is obviously a tiny amount of money to me. If we picked someone from the welfare line and gave them the same money, this would represent all of their income, yet they'd be considered independent, but they wouldn't really be. This thinking is kind of silly.

I encourage institutions and large owners to behave like owners and think carefully about what causes to take on.

Munger: The cause of reform is hurt not helped when an activist makes an idiotic suggestion like saying that having Warren on the board of Coke is contrary to the interests of Coke. Nutty behavior undermines their cause.

Buffett: It's like having a slicing machine in an apple orchard. The machine picks up things like rocks, so you program it to slice only red round things, but when red balloons come down the conveyor belt, the machine doesn't know what to make of it.

Institutions are coming around to new ways of thinking. Hopefully, with evolution, they'll think about what's actually good for the shareholders of the company.

Finding Good Investment Advisors

The question of finding investment advisors is a hard one. When I was winding up my partnership [in the early 1970s], I was returning a fair amount of capital to people, and they asked me what to do with it. I recommended two people who I felt were exceptionally good and honest: Sandy Gottesman, who just joined Berkshire's board, and Bill Ruane [of the Sequoia Fund]. They were contemporaries of mine, so I knew their results and how they'd achieved them, which is critical. I don't know today's managers, so I can't recommend anyone.

The fact that I only knew two shows the difficulties of finding someone good. The promotional types going around to institutions today are not likely to be good – or have high integrity.

I read an article [in the Wall Street Journal last week] about the two fellows who founded Google and all the problems they'll have with their new-found riches – I almost sent a sympathy card. [Laughter.] They don't have a big problem. They're smarter than the people coming to them. The people with the problem are the people trying to sell them services and want to convince them that they have a problem.

It's merchandising. You don't need these people at all in investing – all these professionals who say you're going to be in big trouble if you don't listen to them. They're selling.

It reminds me of when I asked my former brother-in-law: "How do you get farmers to pay you to sell their cow to Swift or Armour?" He replied, "Warren, it's not how you sell 'em, it's how you tell 'em."

The Investment Advisory Business

Munger: Mutual funds charge 2% per year and then brokers switch people between funds, costing another 3-4 percentage points. The poor guy in the general public is getting a terrible

product from the professionals. I think it's disgusting. It's much better to be part of a system that delivers value to the people who buy the product. But if it makes money, we tend to do it in this country.

Hedge Funds

I think people who invest in hedge funds, in aggregate, are unlikely to do well. Hedge funds are in the midst of a fad. It's distinguished by an extraordinary amount of fees. If the world is paying hedge funds 2% and a percentage of the profits, and the losers fade away, then it won't be good for all investors. Obviously, some will do well, but not in aggregate.

Munger: Why would you want to invest with a guy whose thought process says, "If a second layer of fees is good, then let's add a third layer."

Buffett: Maybe [high fees] are what the traffic can bear, but that reflects an attitude. It's a basically unfair arrangement. In effect, [hedge fund managers] are getting four times standard fees. And I'd bet they don't have all of their own money in their own funds.

Charlie and I both ran partnerships that would generally be classified as hedge funds. There are some similarities, but I don't think we had quite the same attitude that the present managers have.

The fund of funds stuff – it's really unbelievable, piling on the layers of costs. People don't become geniuses because on the door it says "hedge fund." But they may be good at marketing – in fact, if they're good at this, they don't need to be good at anything else.

Willingness of Banks to Deal With Shady Characters

Munger: It's amazing what goes on. Salomon was at least as disciplined and rational as other investment banks, but by the end Salomon was begging for investment business from Robert Maxwell, whose nickname was "The Bouncing Check." You'd think if this was his nickname, investment banks wouldn't be chasing his business.

Buffett: The day they found him bobbing [in the water; he committed suicide as the scandal about his misdeeds broke], we [Salomon] sent money to him in exchange for money he was sending to us, but he didn't pay. So, we went to England to collect from his sons and it was a mess. We got what we deserved.

To an investment banker, his earnings would be affected to a significant way if he wrote a few more tickets to Maxwell. You have to control this if guys can make money by bringing dubious things in the door.

[Buffett and Munger chuckled to themselves as they recalled Salomon doing business with another shady character they didn't name.]

Munger [dripping with sarcasm]: That was a wonderful experience. Warren, Lou Simpson and I were all on the board [of Salomon], we were the largest shareholders, and we said, "Don't do

business with this guy." But they ignored us and said that the underwriting committee had approved it.

Buffett: He had a neon sign on him saying "CROOK." He did go to jail. Incidentally, he claimed to have owned a lot of Berkshire stock and to have made a lot of money on it, but I checked the shareholder records and couldn't see it. It could have been in street name, but for a block that big, I think I would have found it [so he has probably lying about his Berkshire holdings].

Share Buybacks
The equation is simple, but practice doesn't always follow logic. Assuming you've been honest with shareholders [in communicating enough information so they can estimate intrinsic value], then if your stock is far below intrinsic value, buying it back adds a lot of value. The Washington Post did this and Teledyne bought back 90% of its stock over time.

Today, stock buybacks are popular. The underlying rationale – not the professed rationale – is that people hope the stock price won't go down. But often this doesn't make sense for shareholders. If the stock is underpriced, buy it back with excess cash; if it's overvalued, don't buy a single share.

If we wanted to return cash to shareholders, we'd go to them and say, "Our stock is cheap and we're going to return cash to you by buying it back."

Dividends and Frictional Costs
In terms of dividends, you get into an expectational problem. Most public companies don't bounce around their dividend from year to year (although this is very common in private companies and Berkshire subsidiaries) because investors come to rely on it. So once you establish a dividend policy at a public company, think a long time before changing it.

Munger: The total amount paid out in dividends is roughly equal to the amount lost in trading and investment advice, so net dividends to shareholders are zero. This is a very peculiar way to run a republic.

Buffett: In a *Fortune* article I published in 1999 [Mr. Buffett on the Stock Market, 11/99], the frictional costs are equal to the total amount paid out in dividends.

Companies should be paying out dividends. Take See's Candies: we haven't figured out a way to grow it, so we can't reinvest, so something approaching a 100% payout [of profits] would make sense [were it a public company]. Most managements want to ensure regularity [of dividends], so they go with a conservative level [below 100%].

We think about this at Berkshire. If we didn't think we could put it [all of our excess cash] to work, then we'd pay it out. But we expect – and this is reasonable, I think – that we will have the chance to put it to work.

[If we decided to return cash to shareholders and] if our stock wasn't underpriced, then we'd probably pay out a dividend – but don't count on it anytime soon.

Stock options

Congress has no business legislating accounting. It was a disgrace when Congress 10 years ago effectively bludgeoned Arthur Leavitt into backing down on expensing stock options, at the behest of big corporate contributors. In a very significant way, this accelerated the [accounting] abuses of the late 1990s.

The Senate voted 88-9 to say that it's more important to have stock prices go up than to have accurate expenses. All of the big auditing firms endorsed their big clients' views, so they could report higher earnings. They [the auditing firms] have now shifted completely [and support expensing options].

The compromise was the firms were given the choice of expensing options or showing their cost in the footnotes – and 498 of the S&P 500 companies chose the latter.

I suggest that you write to your Congressmen and tell them that FASB knows more about acting than they do.

In Google, type in "Indiana" and "pi" and you'll find a site [here's one] that relates how, in 1897, the Indiana state legislature voted to round pi to 3.20 because it's an easier number to work with. It passed the Indiana House, but by the time it got to the Senate, a few people managed to get it shot down.

In 1993, the U.S. Senate cleansed the record of the Indiana House by changing the rules on something they knew nothing about [stock options]. 88 senators declared the world was flat because big donors said it was thus.

Munger: The people who voted this way were *way* worse than in Indiana. Those people were stupid. These people [the 88 Senators] are stupid *and* dishonorable. They knew it was wrong and did it anyway.

[I've written the following columns on stock options: The Stock Option Travesty, Stock Options' Perverse Incentives, Rebutting Stock Option Defenders and Coalition of the Greedy.]

IPOs

Munger: It is entirely possible that you could use our mental models to find good IPOs to buy. There are countless IPOs every year, and I'm sure that there are a few cinches that you could jump on. But the average person is going to get creamed. So if you're talented, good luck.

IPOs are too small for us, or too high tech, so we won't understand them. So, if Warren's looking at them, I don't know about it.

Buffett: An IPO is like a negotiated transaction – the seller chooses when to come public – and it's unlikely to be a time that's favorable to you. So, by scanning 100 IPOs, you're way less likely to find anything interesting than scanning an average group of 100 stocks.

The seller of a $100,000 house in Omaha will never sell for $50,000. But if 100 entities each owned 1% of a basket of homes in Omaha, the price could be anywhere.

You're way more likely to get incredible prices in an auction market.

The Importance of Math
[When asked why math reflects reality, Munger said:]

It's just the way it is. If you want to understand science, you have to understand math. In business, if you're enumerate, you're going to be a klutz. The good thing about business is that you don't have to know any higher math.

Buffett: It may be an advantage not to know it.

Munger: Yes, it is. If you know it, you feel the need to use it.

Comments on Philip Fisher
Phil Fisher was a great man. He died a month ago, well into his 90s. His first book was Common Stocks and Uncommon Profits in 1958. He wrote a second book, and they were great books.

You could get what you wanted from the books (I only met him once). Like Ben Graham, it was in the books – the writing was so clear, you didn't need to meet them.

I thoroughly enjoyed meeting him. I met Phil in 1962. I just went there. I'd go to New York and just drop in on people. They thought that because I was from Omaha, they'd only have to see me once and be rid of me. [Laughter.] Phil was nice to me. I met Charlie in '59; he was preaching a similar doctrine, so I got it from both sides.

Munger: I always like it when someone attractive to me agrees with me, so I have fond memories of Phil Fisher. The idea that it was hard to find good investments, so concentrate in a few, seems to me to be an obviously good idea. But 98% of the investment world doesn't think this way. It's been good for us – and you – that we've done this.

Risk of Holding Assets at Banks or Brokerage Houses
As a depositor in major banks and brokerages firms, I wouldn't worry. We have a too-big-to-fail view toward large institutions to protect depositors – though this is not true of equity holders or margin accounts.

Thinking About the Odds of a Nuclear Attack
You are quite correct that people tend to underestimate low probability events when they haven't happened recently, and overestimate them when they have.

On the nuclear question, you can do the math easily – the question is whether your assumptions are right. If there's a 10% chance each year [of an attack], then there's only a 0.5% chance it doesn't happen sometime in the next 50 years. But if the odds are only 1% each year, then there's a 60% chance you get through the next 50 years.

Corporate Profits as a Percentage of GDP
I don't see how corporate profits will move up as percentage of GDP.

Recommendations for Audit Committees
[During the opening business-of-the-annual-meeting segment of the meeting, Buffett put four slides up, each with a question that the audit committee of Berkshire Hathaway asked the auditors, and the response. This was taken nearly word-for-word from his 2002 annual letter, so I've just reprinted this section from that letter below.]

Buffett: If such questions were asked every year – or better yet, every quarter – there would be a lot fewer accounting problems…They should be asked and the answers should be put into the record. It would have a very helpful effect. It puts the auditors on the line. I've been on many boards and in retrospect many things went by that I wish the auditors had brought to my attention…I noticed that in Google's Owner's Manual, it said that if the numbers are lumpy when they come to us, they'll be lumpy when we report them to you.

Excerpt from 2002 Berkshire Hathaway annual letter:

> **The Audit Committee**
> Audit committees can't audit. Only a company's outside auditor can determine whether the earnings that a management purports to have made are suspect. Reforms that ignore this reality and that instead focus on the structure and charter of the audit committee will accomplish little.
>
> As we've discussed, far too many managers have fudged their company's numbers in recent years, using both accounting and operational techniques that are typically legal but that nevertheless materially mislead investors. Frequently, auditors knew about these deceptions. Too often, however, they remained silent. The key job of the audit committee is simply to get the auditors to divulge what they know.
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> To do this job, the committee must make sure that the auditors worry more about misleading its members than about offending management. In recent years auditors have not felt that way. They have instead generally viewed the CEO, rather than the shareholders or directors, as their client. That has been a natural result of day-to-day working relationships and also of the auditors' understanding that, no matter what the book says, the CEO and CFO pay their fees and determine whether they are retained for both auditing and other work. The rules that have been recently instituted won't materially change this reality. What *will* break this cozy relationship is audit committees unequivocally putting auditors on the spot, making them understand they will become

liable for major monetary penalties if they don't come forth with what they know or suspect.

In my opinion, audit committees can accomplish this goal by asking four questions of auditors, the answers to which should be recorded and reported to shareholders. These questions are:

1. If the auditor were solely responsible for preparation of the company's financial statements, would they have in any way been prepared differently from the manner selected by management? This question should cover both material and nonmaterial differences. If the auditor would have done something differently, both management's argument and the auditor's response should be disclosed. The audit committee should then evaluate the facts.
2. If the auditor were an investor, would he have received – in plain English – the information essential to his understanding the company's financial performance during the reporting period?
3. Is the company following the same internal audit procedure that would be followed if the auditor himself were CEO? If not, what are the differences and why?
4. Is the auditor aware of any actions – either accounting or operational – that have had the purpose and effect of moving revenues or expenses from one reporting period to another?

If the audit committee asks these questions, its composition – the focus of most reforms – is of minor importance. In addition, the procedure will save time and expense. When auditors are put on the spot, they will do their duty. If they are not put on the spot . . . well, we have seen the results of that.

The questions we have enumerated should be asked at least a week before an earnings report is released to the public. That timing will allow differences between the auditors and management to be aired with the committee and resolved. If the timing is tighter – if an earnings release is imminent when the auditors and committee interact – the committee will feel pressure to rubberstamp the prepared figures. Haste is the enemy of accuracy. My thinking, in fact, is that the SEC's recent shortening of reporting deadlines will hurt the quality of information that shareholders receive. Charlie and I believe that rule is a mistake and should be rescinded.

The primary advantage of our four questions is that they will act as a prophylactic. Once the auditors know that the audit committee will require them to affirmatively endorse, rather than merely acquiesce to, management's actions, they will resist misdoings early in the process, well before specious figures become embedded in the company's books. Fear of the plaintiff's bar will see to that.

Behavior of Accountants in Tax-Avoidance Schemes
Some of the tax shelter proposals that were sponsored by the most prominent auditing firms were absolutely disgusting. [Such schemes are one of the] reasons why the middle class pays more taxes than it should.

Berkshire is a heavy contributor to the Treasury. As I pointed out in the annual report, if only 540 contributors paid what we did last year, no-one else would have pay anything – corporate, personal, social security, etc. taxes.

Sure, we buy tax-exempt bonds sometimes but we pay full 34% taxes on our capital gains.

Munger: You'll better understand the evil when top audit firms started selling fraudulent tax shelters when I tell you that one told me that they're better [than the others] because they only sold [the schemes] to their top-20 clients, so no-one would notice.

Buffett: And the lawyers wrote the opinions [blessing these schemes] – don't leave them out.

We had people come to our office, from top auditing firms – but not our auditors [Deloitte & Touche] – and they wanted us to sign confidentiality agreements for schemes to set up 20 offshore trusts, etc. It was designed to be so complex and spread out that no [IRS] agent could figure out the totality.

It makes everyone else pay more. I was a little hard on Pamela Olsen [Assistant Secretary for Tax Policy at the U.S. Treasury, who Buffett criticized in his annual letter (pages 6-7) for accusing him of "playing the tax code like a fiddle"], but I applaud Pamela on her work exposing this.

NYSE's Specialist System
Munger: Generally speaking, I think the specialist system has worked pretty well for a long time. Yes, there have been a few abuses, but I'm not that horrified that some guy who stands there all day makes a lot of money.

Buffett: You should know that Charlie actually had a specialist firm that was the specialist on General Motors on the west coast for 13 years.

Fraud By and On Insurance Companies
[In response to a compliant by a shareholder that his insurance company had – he claimed – defrauded him on a Workman's Comp claim, Buffett said:]

There is plenty of fraud in various aspects of insurance. In automobile insurance, we have fraud units.

We have lost more money in Workman's Comp insurance than just about any other line in terms of aggregate dollars. It's been a tough period. We have one small direct seller of Workman's Comp insurance in California, and then Gen Re does Workman's Comp reinsurance, and it's

been a bloodbath – the rates haven't covered the losses. There's been a fair amount of fraud, especially in the direct lines.

Many companies that have been in the Workman's Comp business, especially in California, wish they hadn't. They haven't made money from it.

Munger: If a company gets into a lot of trouble by fraud practiced on it, and its own affairs are disrupted, then it's just human nature to give customers a hard time.

But the main fraud isn't by insurance carriers against small businessmen, but by the doctors, lawyers, etc. doing it against the carriers.

Asbestos and Tort Reform

Munger: What's happened in asbestos is that a given group of people get mesothelioma – a horrible cancer that comes only from asbestos exposure and kills people. Then, there's another group of claimants who smoked two pack of cigarettes a day and have a spot on their lung. Then you get a lawyer who gets a doctor to testify that every spot is caused by asbestos. Once you effectively bribe a doctor, then you can get millions of people to sue on fears of getting cancer.

But there's not enough money [to pay all of the claimants], so people who are truly harmed don't get enough. In a southern state with a jury pool that hates all big companies [you get big judgments], but lawyers are stealing money from people who are hurt and giving it to people who aren't entitled. It's a bonkers system, but with federalism [state's rights], there's no way to stop it. The Supreme Court refused to step in.

The Manville [Personal Injury Settlement] Trust [created when Johns Manville went into bankruptcy; it separated the operating company from the asbestos liabilities; Berkshire bought the operating company and the proceeds went into the trust to pay asbestos claims] had more new claims last year than in any year – and the company last mined and sold asbestos 35 years ago.

Trying to buy people off is like trying to put out a fire by dousing it with gasoline. With word processors, lawyers can easily produce countless claimants. But only 25% of the money goes to claimants – the rest goes to the lawyers, doctors, etc.

The only people who can fix it are the Supreme Court or Congress. The Supreme Court – some people would say rightly – refused to get involved [but I say] they chickened out. And Congress, given the politics, has yet to step in.

There's an important lesson here: Once wrong-doers get rich, they get enormous political power and you can't stop it, so the key is to nip things like this in the bud.

It would be easy to fix the problem: the right way is to say we're not going to pay off all these little claims.

Buffett: We own Johns Manville and their behavior was reprehensible.

Munger: Johns Manville's behavior was one of the worst in the history of Corporate America – they knew asbestos hurt people and covered it up to make more money.

Buffett: We have no connection to this. The Manville Trust has billions of dollars and has been around for close to 20 years.

It didn't have a record number of claims last year due to new injuries. Rather, it's a honey pot. But they're only paying 5% on claims, so the guy who's been drastically injured is only getting a small amount. It's not the right way to do it.

Regarding the proposed legislation [in Congress]: in the end, we didn't support it. It wasn't the answer we needed.

The Supreme Court, when they ducked it, they left a problem that will be around for decades and decades.

Munger: If you want to be cynical, look at the perjury. There are only three solvent companies left [facing asbestos claims], so [surprise!] plaintiffs can only remember those three names [when recalling which products they were exposed to decades ago]. It's a case of perjury being suborned by practicing lawyers.

Immigration

Munger: I'm very pleased when the smartest people come [to the U.S.] and almost never pleased when the very bottom of the mental barrel comes in.

Buffett: Over the past 200 years, we started with four million people and we now have over 30% of the GDP of the world. We've been characterized by lots of immigration. Whether that's responsible for our success, I don't know, but I suspect so. I don't think we've been hurt by immigration.

I think Charlie would like to be the admitting officer. It would work pretty well, but it's not very practical.

ADVICE ON LIFE AND OTHER

Keys to Happiness and Success
Munger: Just avoid things like racing trains to the crossing, doing cocaine, etc. Develop good mental habits.

Buffett: I get letters every day from people in financial trouble. Often it's health related, but it's often debt. They're decent people, but they've made a mistake. They're not going to catch up, so I tell them to just file for bankruptcy and start fresh. In most cases, they should have done so a lot earlier.

Munger: Avoid evil, particularly if they're attractive members of the opposite sex.

Buffett: If you hang out with a bad bunch, it's likely to rub off.

Look at the people you like to hang out with. What qualities do you like about them? Why don't you copy them? And look at the people you don't like. What don't you like about them, and can you stop doing these things?

Munger: If your new behavior earns you a little temporary unpopularity with your peer group, then the hell with them.

Buffett: This reminds me of the old lady who was asked what she liked about being 103 years old? She replied, "No peer pressure."

Book Recommendations
Munger: One book I like is Deep Simplicity by John Gribbon. A perfectly marvelous book. But it's not published yet in North America. [Here is a link to the book on Amazon.com's UK web site; I've heard they'll ship to the U.S.]

Buffett: I've been reading A Short History of Nearly Everything. It's interesting to see people in the mid-18th century trying to estimate the weight of the earth. Isaac Newton spent most of his career trying to turn lead into gold – he would have been a good stock broker. [Laughter.]

Munger: He was the smartest guy on earth yet got caught up in the South Sea bubble.

Munger: If you want to read one book, read the autobiography of Les Schwab [Les Schwab Pride in Performance: Keep It Going]. He ran tire shops in the Midwest and made a fortune by being shrewd in a tough business by having good systems.

Buffett [underscoring how impressed he is by what Schwab achieved]: How do you make money selling tires?!

Munger: He made hundreds of millions selling tires.