

Wesco Financial Corporation (WSC) 2010 Annual Meeting (May 5th, 2010)

Speaker: Chairman and CEO Charlie Munger

Charlie Munger: The plan is to follow the procedure from last year and then talk about interesting issues. Regarding his general observations, he is flabbergasted that so many people came to Pasadena after going to Omaha. He thought we would have had our fill of his opinions but apparently there are “addicts” out there. Wesco is a quiet enterprise. It has a \$2B market cap, up from \$20M at the time they started buying back stock. That is a failure in comparison to Berkshire Hathaway (BRK), but compared to other companies it looks alright.

The failure rate of S&Ls has been very high and they are one of the only survivors. Why is the casualty rate of S&Ls in California so high? They tried to live off of a modest spread between their loans and their costs of debt. Relying on a small spread is a tough way to live if you are ambitious. If you are determined to grow 10-20% per year in assets and earnings, what you will tend to do in order to achieve this goal will lead to ruin. Ultimately, competitors drop loan standards and you either fire people to cut your overhead [due to lack of business] or you lower your own standards as well. Most people follow this race to the bottom, a process that destroys the entire industry. This was what the Greeks called a tragedy-- you could see it coming but you couldn't escape it. At the bottom tick just about everyone in Wall Street could have gone under unless the government had saved them. This whole process leads to a competitive deterioration of asset quality and leads the system to ruin. This is an obvious dynamic.

Why hasn't mankind developed a system to prevent this ruin? What happens is that active people get rich and powerful and they buy the favor of politicians and then auditors go along. At the depths of the crisis, it was deadly serious. We were on the edge of something that could have taken the whole civilization into severe difficulty. We gave up the stupidity after WWII. We took our money to our enemies and helped them recover. This was one of the best decisions ever made. It worked out beautifully. This did not happen after WWI and that's how Hitler rose. That certainly did not turn out well.

Why can't we do something smart like the Marshall Plan in finance? What happened is that all our elites failed us, especially academic elites. Faulty risk control mechanisms were taught in business schools and eventually law schools adopted the belief that everything is based on a Gaussian distribution. This turned out to be very wrong, despite the high all the IQ people analyzing the financial markets. Why do some people make good decisions and other smart people make bad decisions? Some bad choices come from incentives inherent in our civilization. People start to want to spread and dominate. How do you remain in the minority who stays sane when everyone else is going crazy? You have to be skeptical of common wisdom and keep your head when everyone else is losing theirs.

Who else failed us? The academic types thought that diversification was the secret to success. Diversification may be a way of avoiding disaster but does not represent a path to success. A person is not much of a teacher if all he or she can do is prevent disaster. This is why he calls it de-worsification. BRK owns things they know a lot about [instead of blindly]. The concept of beta or volatility is asinine. It isn't always bad ideas that cause bad outcomes but good ideas taken to excess. Obviously if you own very volatile stocks your returns can be volatile day to day. The main problems in life can only be solved when you know what works, what doesn't and why.

Very high IQ people coming out of b-schools are basically useless to us, aside from their own idiosyncratic virtues. These people often tell him and Warren that what they learned in b-school was useless and they like the way Warren and Charlie think. Simple formulas are all that are taught but they are totally useless. B-schools have not done civilization a favor by making the matter easier to teach but useless. If he were running a business school, he would start off with a history of business. That system would steal cases from each of the sub-specialist's repertoire so there would be a lot of cross-academic friction. However, he thinks it is useful to know why GM rose and then failed. He also thinks it would be beneficial to examine why railroads rose, struggled and why are they better investments now. Unfortunately, it is easier to teach beta, which he equated to algebra; where you can plug in values and find an answer.

A friend of his went to a school that taught him how to reduce working capital by starving suppliers. They taught him to use simple algebra to squeeze suppliers. When he has tested on this material, he gave the calculation on the exam but told the teacher that it was asinine and that would never do that. We should all want to have a partnership with suppliers in which everyone trusts one another. He is a very prosperous guy and did well because he rejected the business school stupidity. It is very important for students to be independent and to question what they learn.

Gilford Glazer [a longtime friend of his], came back from the war and went to HBS. But his father's little machine shop needed attention and he asked them to defer acceptance for a year so he could help his father. After a year he contacted HBS and asked for another year. The guy from Harvard then asked him how many employees he had last year at this time. He answered 50. Then, when he asked him how many employees he had now, the answer was 900. The Harvard guy laughed and told him he didn't need to go to business school. That kind of approach is no longer present at HBS. They were probably wiser then than they are now.

Gilford's father gave him good advice when he came back from the war. As a general principle, he wanted to sell people things that are good for them. He didn't want to operate casinos or sell drugs. He believed a firm should only do things that were good for customers and now he is a billionaire. A lot of the ethical approach of the elder Glazer is gone today. Competition takes things to excess.

Charlie then changed the subject to soccer. Soccer is a game that is very competitive and it is hard to win when the other team has a player that is unusually good. If you let the players do what they want to do they will work mayhem on that great player. Therefore, the soccer referee has to limit the mayhem. This is an important role in soccer. This is the role that government should take with investment bankers. You can't expect competitive people like them to reign themselves in. It's understandable that if you recruit these competitive people that it leads to too much aggression and ethical standards go down. Something like that has happened in investment banking.

At the end, Lehman (LEH) was pathological. The totally crooked and crazy operators who originated mortgages and then packaged them into securities were behaving in a way that Glazer's father would not have recommended. In the end it does not work well for those who sell things that are bad for their customers. The disturbing thing is that most of these people think it is someone else's fault. Hitler said when he was in that bunker that it was too bad that this happened. He believed that the problem was that the German people hadn't appreciated their leader enough.

This is similar to what people on Wall Street think now. There needs to be an adult in the room. But the government was not a good referee of mortgage originators. They had 200 people in OFHEO whose job it was to regulate Fannie and Freddie and right under their noses both went hopelessly insolvent and had phony accounting. Some of this was due to the desire at Fannie and Freddie to generate bonuses. In any case, you are not going to solve the problem by saying to these entities "do whatever you want because we have a regulator here to watch." The regulator is likely to be co-opted or be subject to inertia. The SEC failed us and let Madoff do what he did but they ignored it because it was difficult. Our problems cannot be solved by letting these people who failed regulate more. We should curtail the activities that are permitted. We need to limit what Goldman Sachs (GS) can do. We did that after the 1920s due to the wretched excess of the 1920's. They passed a law that said commercial banks couldn't do investment banking and for a long time the investment banks stayed out of trouble and maybe even were too cautious

We don't need the capital allocation process of our civilization mixed up with a casino. Commercial and investment banks should be separated. We should have commodity markets, but not within the banks. They should not be able to gamble on derivatives or agriculture hedging. The investment banks should be allowed to be an underwriter, sell securities to customers, get revenues from M&A, and run accounts for hedge funds. There is a lot of legitimate activity that can be done without scandal and trouble. Why do they have to do everything else? Munger would really curtail what is allowed to be done. Investment banks could spin off these businesses if they like. JP Morgan was reputable after Morgan Guaranty was split off. Unfortunately, nobody else believes this like Munger does.

It is very hard being up there in his 87th year. He said he feels a lot like George Burns. According to a story, they sent Burns 4 girls to sing to him on his birthday and he couldn't handle it. He said that one of the girls will have to come back tomorrow.

We need the equivalent to the soccer referee--but not OFHEO. There needs to be legislation that says that insured deposit taking precludes you from engaging in other risky activities. If there is no formal legislation, you have what happened to LEH. All problems were solved by doubling down, the accounting gets wretched, you take things off the balance sheet and everything goes bonkers. This is dangerous for the rest of us.

Charlie thinks GS has the best morality and best wisdom of all of the banks. Accordingly, the government should not jump on the bank that is the best. The government just stumbled into this SEC investigation and it is not an appropriate response. He thinks the world would work a lot better off without this stuff [derivatives]. It worked well without them before.

He knows of a place where poker is played. There, the more complex the game, the easier it for the best players to beat the patsies. This is the same thing happen on Wall Street. People now want to be more like him instead of being engineers. When people are allowed to play complicated games they will clobber their own customers who are not as experienced. When a guy is offering you free money then don't listen to the rest of the sentence. This is the Munger rule. Korea and Mexico got caught up in buying derivative contracts. The carnage from the complex products has been terrible. It is a mistake to create products that rook your own customers. Who is going to be the wolf and who is the going to be the sheep? Just guess.

There are a lot of activities that we can do without in our current financial scene. But the vested interests in this stuff are just so big. The accountants are part of the problem here. There is a new accounting standard. Assets are good until you reach for them or actually need them. Derivative books are full of \$400M holes. These books are full of assets that are being valued differently by each of the parties. We don't need mark to myth accounting. Accountants learn too much math and too little sense. Over-reporting assets and earnings and under reporting assets and earnings are not the same. The real risk of over-conservatism is just about 0. The accounting changed because people wanted to write their assets up, not down.

He remembers when the Morgan Bank decided to go along with crowd in order to retain their traders. They had to go to looser accounting standards. This led them into further derivative trading and the books went nuts. There is a huge advantage to trading derivatives over the counter (OTC). If you are the only market maker and the other person wants to get out-- they have to come to you. Plus there is mystery in terms of pricing. Banks have unclear derivative transactions in the 100's of billions of dollars on their books. It is like hydrogen and oxygen sitting next to each other on the sidewalk but people just continue to book profits and somehow believe they are actually earning them.

Is there an example of a prudent decision like the Marshall Plan after WW2? The George Washington of Singapore, Lee Kuan Yew, decided to marry the smartest girl in his class. Their son is now the PM of Singapore. He was a very practical man. He didn't want people dying of Malaria so he drained all the swamps and didn't care if a little fish went extinct. He didn't like the drug problem and he looked around the world to solve the drug problem. He found the solution in US by copying the US Military's policy. Any time you can be tested and if you fail you go to jail. If something was going to grow like cancer he would check it hard with the wrath of God. He turned a country with no resources or agriculture into a prosperous country, starting from 0 mph. We need to pay more attention in our country to the Singapore model.

They hate Lee Kuan Yew in liberal arts colleges. They hate that Singapore doesn't allow free speech. But, time after time he has been successful and even the leaders of China came to Singapore and learned from Lee Kuan Yew. Charlie doesn't care whether the cat is black or white, as long as it catches mice. In many respects the US is too damn permissive. We don't step hard enough on things that can grow into trouble. If some of the silly accounting practices had been stopped, then none of this would have happened.

Take Enron, for example. The ability to record profits upfront on uncertain derivative contracts was insane. The SEC needs more sense and to learn to say no. People will always ask to be able to do the wrong things.

If we don't tell them no, we are going to continue to have trouble. Not only do accountants have mathematical consistency that doesn't make sense, they also follow the rules and then blindly conclude that they have the right answer. They created a rule based on past experiences at banks. After a long period during any boom, bad debt reserves at a bank go to \$0 when they should go up. We should throw out that system and find one that makes more sense. To get consistency, the profession came up with a rule that when you are on the edge of bankruptcy (creditors are terrified), you have made a huge profit because you could theoretically buy your debt back at a large profit--if you had cash of course.

There is Alice and Wonderland and nut case accounting in the US. These people need to be thrown out and people who think more like Lee Kuan Yew need to be installed. Jamie Dimon of JP Morgan is actually complaining about this but he is the only one. Charlie takes his hat off to him but his derivative book needs to go away. He should not run a gambling parlor next to a legitimate business. Actually, in recent years, some of our banks actually bought casinos. "Why run a casino in drag when you can run a real casino?"

When it comes to casinos, maybe we should have these things but we should minimize them. Casinos work so well--no inventories and no accounts receivable. It's like god gave you the ability to print money. But real casinos have huge CAPEX and asset requirements. On the other hand, on Wall Street they can create a casino without those requirements. How many of us could resist those temptations to print money?

Some people look at an 87 year old Chairman and worry about succession. Wesco is a historical accident--it should have been merged into BRK. People like this as a club and have bid the price too high for Buffett to be willing to buy it. He and Warren don't like forcing people out in exchange for cash and hate to issue BRK stock for almost anything. So, the inevitable outcome has been delayed. Eventually the price will be right or such a minor blip to BRK that it will eventually be merged into BRK. This place has no logical future. "I have no idea why you like place. I was never all that popular in my youth."

The BRK model--what is different about it? We have decentralization just short of abdication in terms of managing subsidiaries. They employ 28 people in Omaha. But, they have an extreme centralization of cash in Omaha. They allow businesses to buy things that will help their businesses but the cash for the most part comes to Omaha for Buffett to invest. Centralization is as peculiar as the decentralization. There is no big bureaucracy with central rules. People would rather work in small groups where they trust one another. Extreme de-centralization is good, on balance. Averaged out, it provides more benefit than harm. They get a ton of value from centralization of capital. The higher the opportunity cost, the better decisions will be. They can allocate capital to insurance companies or they can buy a whole company. He recently looked at a company in China that he rejected it immediately. He knew he liked BYD more and could buy more of that company instead. The opportunity cost consideration at headquarters leads to better capital allocation.

People now ask him, what the hell has happened to you? You are buying companies that are dependent on technology. BYD and Iscar are the primary examples. Up until recently, Charlie and Warren have shunned high tech. They like shops and roofing shingles more. They don't want to look like Merck or GE and they have historically been different. Why are they doing this? Well, their past behavior was due to inadequacies. The change happened because they developed other models. You should have a lot of models in your head. One of the models in his head is the Northern Pike model. Some businesses are like Northern Pike and come into the business world of stupid trout and gallop through the world like Genghis Kahn. Costco and Wal-Mart are examples of these types of companies. They have a models and systems that make them a great force.

He would never have bought Samsung previously because they surf on the edge of technology. Take Kodak, for example. They had the smartest people and the best patents and it almost went "blooey." What about Xerox? They had great people and engineers but they had a near death experience. When you are a high tech company, when a game changing technology comes around, you fail (quoting Bill Gates). Because of this threat of failure they stayed out of this sector previously. But now they are in it. The answer is that some of the models got so powerful that they could make predictions that success would happen and the company would continue to grow. If he claimed he could press 800 pounds above his head, people would laugh. But if you saw him actually do it over and over again, you would start to believe that he could do it again. This is exactly what happened with BYD. They created miracles that kept on happening.

What has happened is that they have gotten confidence to enter places they hadn't been before. They are clearly not going to do this very often. There are not that many BYDs. They don't want to be the new Klenier Perkins of Southern California. He actually hates the venture capital business. When you bet on something like BYD, it is not just BYD. You are betting on something that is close to proven. It is fun to watch a business tackle the biggest problems we face in this world. Cheaper solar power and better batteries are holy grails. Mass production of better cars for people in China is a holy grail. The electric car has to be made for places where you can't breathe the air. At every major university and every energy company they are trying to develop these technologies. How are some people in China in the lead? They have unique individuals and a unique culture. Chinese engineers just work harder than other. He thinks BYD will succeed and it will help us all if they do. We have to use more sunlight in order to solve power problems and pollutions problems. A better battery technology is part of that. He recently drove a BYD vehicle even though he usually drives Mercedes 500. This BYD car weighs more due to the weight of the battery. He foresees that there is going to be a car like the Mercedes that works on a battery,

Mercedes just signed a cooperation agreement with BYD. Why would they do that? The answer is that they have tested the battery. They can see the future coming and can see why it will work. The right people are getting together and if he lives long enough he will be driving a battery car. He does not advocate everyone get into technology, especially since he and Warren got rich following their old model. It is just safer. He thinks he is right about BYD even though it wasn't how he came up. He can still learn even though he is 86.

Question 1: Referring Wall Street, are distorted incentives between banks and regulators the problem? There is a huge pay discrepancy between regulators and bankers. What happens when they finish public service and then move into the private sector? Should that be curtailed?

He thinks that the revolving door between Wall Street and the US government regulators is a big problem. Lee Kuan Yew of Singapore decided to pay civil servants more to get around this problem. Our main problem is not corruption-- it is cognitive inadequacy.

Question 2 (Whitney Tilson of T2 Partners): Jimmy Cayne and Alan Schwartz recently testified in front of Congress that there was nothing that they could have done to save Bear Stearns. Should we have these congressional hearings?

If you haul people in front of Congress, hanging onto any shreds of dignity, people will blame others instead. Congress does it in part because they are mad and they want drag people in there. It's like putting a dog's nose in it after it has an accident in the living room. Some people will even say that they just don't remember.

Question 3: (David Winters of Wintergreen Fund) When do you anticipate insurance pricing to improving and to generate a greater float at BRK?

Odds are the float will not grow much. It may even decline. It is hard to increase float from the current levels. There have been some miracles in the past and they have a wonderful system to increase float, but it is unlikely.

Question 4: Should America get back to basics? The crisis is not forcing us to back to basics. We have lost sight of manufacturing and infrastructure. People seem to be missing the importance of these things. What does Charlie think?

Of course the county has more troubles now than we are used to. Certain forces look difficult to handle and we somehow can't change things like education. That said, he is not overly pessimistic. People ask him, how can you be happy in California with the legislature? There are certified nuts on both sides of the aisle hating one another? It's true that we have all of these troubles but we have a great climate and are getting an influx of Asian people. The truth is that when you get enough of a mess, you get a correction. The failure that's bothering people so much looks like a ray of sunshine to Munger. People need to be provoked by a

lot of failure. Maybe a partial dawn is coming while to some it looks like the end of the world. "I hope I'm right."

Question 5: How do you develop the temperament of the Berkshire mode?

That's a very good question. Why do we have so much failure? Most people don't understand the main model. Look at East Germany. People were caught under Communism. The best 5M people got to leave. The worst 17M stayed and of course that ruined even a great country Germany. This is true in the US's urban cities. The best people have left and the problems can't be fixed easily. You can't fix brain cancer when you already have it. You need to protect against it by stepping on things before they get too bad. The whole EU has problems like East Germany now. You can't blame Greece's politicians. They acted based on the incentives in front of them. You better cope with the problems if they are in your face.

We would do better coping with complex systems if we thought about them more. Lee Kuan Yew thinks things through. The fact that it is unpleasant does not stop him. Affluence and poverty can both ruin children. Charlie recommends a much more rational and tough-minded approach. An ounce of prevention is not worth a pound; it is often worth a ton.

Question 6: Do we need for a smart electrical grid in the US? When it comes to Burlington North Santa Fe (BNSF), could the vast right of ways be used for building the grid? Would that be good for BRK shareholders?

He has ever heard anyone ever suggest that. But, he can't rule it out because they use the railways for pipelines now. The grid he has in mind has to be up in the air. He can't imagine the BNSF grid full of utility towers. "Put me down as skeptical-- I don't see any potential synergy."

Question 7: BYD has a brilliant leader. What happens if he isn't there?

There are inevitable risks but Charlie is accustomed to it dealing suck risks when it comes to Warren. [Charlie asked Wang Chuangfu to stand up and show how "frail" he was] BYD actually just moved their HQ into downtown LA. That is a good message since it doesn't look anything like Wall Street.

Question 7: How do you retain good engineering mentality without succumbing to the dark side [relying too much on numbers and formulas]?

One big institution that has a low amount of paralysis by analysis is BYD. They are determined to be rational and they don't like delays. Their culture is so different from what you see in places that suffer from paralysis from analysis. Unfortunately, India has copied our worst faults when they should be copying Singapore's.

Question 8: In his relationship with Buffett, what did Buffett teach Charlie? [Buffett credited Munger with teaching him about a durable competitive advantage at the BRK Annual Meeting]

Buffett is a supportive and appreciative of his colleagues and says nice things. He gave him credit he does not deserve. Munger claimed that Buffett already he knew about competitive advantages. He didn't need Charlie. They do so well in spite of being so stupid. "That's why you are here. You think there is hope for all of you."

Patrick Wolf, the chess player, came to Munger and complemented him. Munger said he certainly does not do better than Wolf. Munger just went where there was no or dumb competition. Wolf goes where the competition is the most intense. [Playing chess against 6 players at a time blindfolded]

Question 9: How do you determine bet size when you make investments? Do you use the Kelly Formula?

They don't use any accounting formulas to determine the size of bets. The Kelly Formula only works when you make bets over and over again. They rarely make bets so the formula doesn't make sense. Their

problem is finding a way to make sensible bets that can make a difference. The formula makes sense for gambling, but not for their style of investing. It is a correct formula, but only for certain types of problems.

Question 10: In terms of the BNSF acquisition, are their incentives in management's compensation to get their margins up [closer to where the competitor's margins are]?

They don't think they have to do one damn thing--they are going to let the CEO Matt Rose do whatever he wants. They are happy to let Matt think about such margin problems.

Question 11: Did he and Buffett share ideas before they formally got together?

He always had someone to discuss investments with. Even Einstein didn't work in isolation. But he never went to large conferences. Any human being needs conversational colleagues. He had enough. He only needed one wife and few pals, at least when it comes to deep intellectual stuff.

Question 12: Excesses in the economy finally caused the blow up. Have they been worked out?

Of course they have not been worked out. What we think of as excesses are the air holes for a diver [meaning that they think they need excesses to survive]. People say to themselves: "I need it and I want it and I should have it." Some people never get over that. If we don't make substantial changes to the system we will have another big mess like the one we have had.

Question 13: What do you think of Central Banks' behavior, especially printing money and changing collateral standards?

Greece is serious. Everyone knew that a Greece-like problem was a risk when forming the union. It's amazing that it actually took so long. There is one problem that is very hard to fix: the EU doesn't want to bail out everyone who has borrowed too much no matter how much trouble they get into. It is very awkward to have a member of the EU go under. In the old days, countries like Ireland got welfare from the EU and Ireland enjoyed a great surge, subsidized by the EU. There are terrible problems on each side; neither is attractive. He is glad he isn't working on it because he has no idea how to solve it. Wisdom is in prevention. Wise people step on big troubles early. Civil servants drift along hoping that God will provide a solution and the problems inevitably get worse.

Question 14: You study people you admire. Who should we study?

There is a lot to learn from BRK. At a BRK meeting, one group of BRK managers said he had been successful following an 80/20 rule: focus on the best 20% of customers. Then, the next man came up with an even more profitable business. But, he specializes in the worst 20% in the world; the people that others wanted to get rid of. Both were correct following completely different strategies. If you are clever enough, you can do well going after what no one wants.

Question 15: In terms of BRK, the questioner wanted to invest but he is concerned about succession.

Speaking for himself, he has much of his net worth in BRK stock. He thinks it will be a great company for many years after they are long gone. He thinks that the culture is amazing and the businesses are great. Few enterprises have been created to need so little talent at the top. It has great momentum and the culture in place should last.

Question 16: Where would you start a circle of competency in investing?

Don't go where the big boys have to be. You don't want to look at the drug pipelines of Merck and Pfizer. Go where there are inefficiencies in which you can get an advantage and where there are fewer people looking at the stocks. Go where the competition is low.

Question 17: A lattice work and a cross-disciplinary approach to thinking are very useful. The questioner

claimed that his constraint is adding to the tool kit, meaning that it takes him longer to learn something as a result of using these frameworks. Is this inevitable or can you speed it up?

Charlie was born a lattice work thinker. He was continually curious. Learning was play, not work. This gives you an advantage. If you have his nature, just do what comes naturally. If you are different then you have to figure out your own damn solution.

Question 18: Why did the government have to step in this time [where it hasn't to the same extent previously] to save the financial system?

It was way worse and the banks were going to go down like bowling pins. The process was just feeding on itself and stuff like this can get worse real fast. No one liked what was unfolding and no one wanted to see what could have happened without the extreme measures. Both the democrats and republicans figured out that something had to happen really fast. England showed us that we had to intervene in our banks and that that approach was better than the original TARP plan. We have wonderful leadership (singled out Hank Paulson) and he is grateful. The problems were very dangerous.

Question 19: Can you talk to the current state of the condo development next to Wesco HQ?

Charlie thanked the questioner for rubbing his nose in a financial failure. He said it's good for him. He decided to help civilization in the hope that people who could afford anything would move in Pasadena and pay a lot of money. In spite of the bad market they are selling condos to the right type of people at a modest loss. They are selling to good people. They are behaving correctly and will continue to do so. Eventually each one of those condos will be worth more than these buyers paid for it. Eventually one condo will be for sale and there will be lots of bidders who take the price way up. It will be good for buyers, bad for Wesco.

Question 20: Some high percentage of Cal Tech students are going to work in finance after graduation. This may not be a bad thing because one day they could be running the place. What does Charlie think of that idea?

It is likely that random person from Cal Tech would do better than [former Lehman CEO) Dick Fuld. But the loss of engineers to finance and to a money grubbing exercise is a problem. They should be designing oil refineries and just because they are better than Fuld does not mean they should go into finance for a living.

Question 21: Can you talk about the state of the insurance market?

Generally speaking, the P&C business is tough. It has some of the problems of high finance when people try to maintain volumes and then eventually underwriting suffers. He would not look at this business as a good investment other than if you wanted to invest in BRK. They are tough minded and can make money in this space. This is not a good business for most other companies. It is very tough with a lot wrong with it. It is so easy to underprice and under-reserve. It is tough to count on smart decision making at the top of a P&C company. It is even more difficult in the reinsurance business.

Question 22: How does he look at the potential BNSF return? Has he read any good books lately?

BRK is doing things based on opportunity cost of capital. They were getting poor returns on their money and what happened was that they thought the deal was good for BRK shareholders. It was better for BNSF shareholders but that isn't a reason not to do it. CEO Matt Rose was a big addition to BRK. He is young and sound. They don't estimate precise return figures. They invest money and hope to make 10% pretax over a long period of time when they are buying equity. Generally, they hope that they will make that 10% but it's not an iron rule. A rough range in the current return environment would include less than 10% pretax from here. This is not a hog heaven period. Interest rates are low and this is one reason stocks are up so much. This is not a world that should make all you people salivate. This world is difficult. There was a short bargain period. Some of us were paralyzed and others didn't have the money. We are facing ordinary adult life now and it is not easy. Thus, we may be wrong about getting a 10% return from buying stocks

now.

In terms of books, all the books about the Great Recession were interesting. He likes the John Paulson story and thinks it is going to create a lot of trouble in America because everyone wants to be him. This will cause everyone to invest in derivatives. He is a nice man but his influence is not positive. He said his own life is like this in that he feels like he is atoning for things that happened in the past. A lot of people who hope they can do well and take their chances regarding whether or not there is a job that suits them.

Question 23 (Ryan Morris of Meson Partners—watch out for this guy: some very smart people think he is going to be a star fund manager): Regarding, the rate of change of business: over time the rate seems to be increasing. Evolution is getting faster. Accordingly, is it harder for a buy and hold strategy to work?

He doesn't know what the next 20 years are going to hold. He has little personal reason to care about it. The rate of change that he thinks is interesting is that of China. There is no precedent of any place to grow as fast at this size as China. These Communist leaders are so different from other communist leaders that he is optimistic. His kind of Communist has an engineering background. We [Americans] are too critical of them. We want them to have specific civil rights rules but China does not have to do it out way. They can do it their way and it is really working. It is not just cheap products. They are coming up the competency curve at a rate that has almost no precedent. No country has ever come up so fast from such a backward condition. People resent China's cheap products. They need to foster more companies and people like BYD who are trying to make the world better and make actual product improvements. He thinks we are going to see a lot more of that from China. He has always liked the Chinese. The restaurant that he used to like so much on Omaha is still there. The Chinese have a great record of handling difficulty. That restaurant is the only business that is still there.

Question 24: At the BRK meeting he mentioned that solar was too expensive for his house. What about wind power?

He doesn't 2nd guess people who run MidAmerican for investing in wind power. In general he is in favor of using more wind and sun power. He thinks solar costs are going to go down in the near future. He does not know if he is right but that's what he thinks.

Question 25: How does Wesco increase its float? Can the relationship with BRK help in that process? Why was BYD made in BRK and not Wesco?

In regards to the BYD question, everything they do that is strategic involves BRK. That's just the limitation of the conditions. Wesco is not a smaller, identical BRK.

When it comes to insurance, there is no way for Wesco to increase its float in a magical way. It is not a fabulous company with great independent prospects. They bought Kort (rental furniture) at a bad time. They will do alright over time but it will be a long grind. People shouldn't analyze Wesco as if were its own entity.

Question 26: The questioner decided to get his MBA. Based on what Charlie said today, he thinks it was a bad idea. Also, will he come and talk to his class?

The MBA label is helpful as long as you don't fall for the wrong ideas. He did a talk one time to a business school class and it lives on pretty well. Warren spends a lot of time talking to students but Charlie doesn't want to talk to b-school classes.

Question 27: If you are running less capital, would you look for small caps?

At BRK they can't look at small caps b/c it is not practical. That is one of the things that is wrong with BRK. He told the questioner that he had the problem of being young and poor. Then, he said that if he were young and poor he would be looking for exploitable opportunities wherever they were.

Question 28 (Alan Schram of Wellcap Partners): Is Kort in just a cyclical decline or is the problem more severe? Will they have to write down the goodwill? Do you disagree with Warren about GS and the Abacus transaction?

He thinks Kort will do ok and be a halfway decent investment. He thinks that it will justify the price they paid. Having said that, they are becoming more dominant in the industry so maybe he is being too pessimistic.

Regarding GS, he just doesn't like that derivatives are allowed all over the place. He thinks they do more social harm than social good. When they got mispriced Warren actually made some bets using those instruments even after writing a letter in 1982 saying that S&P derivatives were a bad idea [and calling them weapons of mass destruction in an annual report]. Despite that, he does not see Warren's foray into derivatives as inconsistent.

Given a world of propriety derivatives, GS did not misbehave. They were just doing what other people were doing. The Abacus deal does have the disadvantage that it is hard to explain. The GS people did not think through how hard it would be to explain to the public. GS will change because Blankfein is a flexible man. They deserve their share of blame for urging the government to stop regulating. It was natural and everyone was doing it. When it comes to Wall Street, anything that transfers risk between consenting adults is OK. But all kinds of things that consenting adults want to do that should not be allowed. One of those is gambling with derivatives at investment banks. But, why is GS the poster boy for insensitivity? It is not fair based on what others were doing as well.

Question 29: What makes a good distribution business? The questioner referenced Coke (KO) and the decision to acquire its bottlers.

Charlie said that he doesn't follow KO that closely. The original structure allowed the lower return businesses to be separated from the profitable concentrate business. In general, he does not like cosmetic changes like that. Thus, he welcomes changes to this model that reverse what was done. He added that the new CEO of Coke is the best one in a long time.

Question 30: Clayton Homes offers a high quality product. Post housing crisis, what are the growth prospects for Clayton?

Kevin Clayton is interested into taking that model upscale to other homes that get around the zoning issues that now exist in the US. Thinks there will be more Clayton style construction in the US going forward. This could take decades but Clayton will gain from what they are trying to do because of the expense of building custom homes. We will slowly get to that point.

Question 31: What are some good books for children interested in investing?

He is not sure that he believes that young children should be exposed to investing. For him, he understands reality better than others. When he is gone and they ask, how much did Charlie leave? The answer will be: I believe he left it all.

If you have the capacity to get wisdom and don't use it then he regards that as a moral failure. That is a Confucian concept. This is why he likes the Chinese. They think similarly.

Question 32: Why do he and Warren read 5 newspapers a day? Will GS have to divest their businesses?

No bank is going to divest its operation unless it is forced to. So, it will depend on what Congress and the regulators decided to pursue.

He reads papers because they contain a lot of intelligence. He likes the Financial Times because it is the most intellectual. But he would read more if had the time. He skims until he finds something he likes and

then he drills down. He likes all the newspapers he reads. He doesn't know anyone who is wise in the practical world who reads no newspapers. Maybe young people will be good at looking at a little keyboard and multitasking. But he thinks they will do worse than him because multitasking is counterproductive. If young people didn't embrace the modern world of multitasking, they would be banished from their social groups. "But what the hell? I have been banished by certain social groups."

Question 33: Charlie spoke very highly of Singapore. Given the problems in the US, would he ever move to Singapore?

He would never leave the US. Singapore could be a good place for someone else. If crime tripled in the US then Singapore could get an influx of rich people from the rest of the world. He doesn't know what is going to happen but he will still be here. He loves the US, despite the flaws.

Question 34: Why did BRK buy re-insures if it is a bad business?

Gen Re is a good business and is very respectable. These purchases are just portfolio investments and they seem sensible to him and Warren. It doesn't change the idea that reinsurance is a bad business in which it is easy to make big mistakes.

Specifically, it is very hard to find these mistakes. You have to judge culture too. Reserves and culture are both important. All these things have to be judged when you are making an investment decision. It is much better to find a no brainer. He likes no brainers like Costco and BYD. But you don't find that many. Therefore, if you are lucky to have enough money [like at BRK], then you have to make a lot of tough decisions when it comes to allocating money. Having said that though, he doesn't feel bad for people with such problems [having too much money].

Question 35: In the US we have moved away from mark to market accounting. How do we deal with this in the future?

At the bottom tick, Wells Fargo (WFC) went down to as silly price. WFC is an admirable bank with a great model. They will certainly have a lot of work to do atoning for mistakes and cleaning up Wachovia. But, it is a good investment, even at the current price. That said, even the best banks seem to drift along with follies of their times and the people are WFC likely have a long list of mistakes. The truth is that they face it and fix it better than other banks.

We may be getting more changes in credit cards because they were issued to people who can't handle them. If he were running a bank he would not give credit cards to "fiscaholics" He doesn't like charging 30% to people who can't handle credit. It offends him but maybe that is just him. [Charlie then asked people to raise their hands if they found such high rates offensive] Based on the response, there are a lot of people who feel that way. He hopes that the bankers are looking at all those people who feel the way he does.

Question 36: What else is he interested in China?

He is interested in knowing more about China but he is happy with BYD. It is hard to imagine finding anything that pleases him as much. He thinks he has had all the good luck he is entitled to in his life when it comes to China. He would be surprised if he ever finds a better company.

Question 37: What are the risks and opportunities at GEICO? Are there other auxiliary businesses they could get into?

They did not cover themselves in glory with the credit card initiative at GEICO. The difference is that they admit their mistakes and they get their noses rubbed in them. He hopes GEICO doesn't find any other auxiliary investments like that.

Question 38: Based on his extensive criticism of accounting in the US, what should we tell our current accounting students?

The people who set the standards have to understand that huge changes are necessary in the interest of the out country. Unfortunately, we are stuck teaching it the way it is because of the CPA test. To someone who teaches account, he said that they hold their noses and just teach it the same way. Accounting is a noble profession that has done wonders for the world. It is a wonderful profession and he hopes that people grow up to change the things that he detests.

Accountants are right to fear making businesses decisions. Thus, he would exempt accountants from liability except for outright fraud. But on the other side they would have to do a lot better at stopping fraud and being more sensible.