

## **Berkshire Annual Meeting 2010**

Note from The Inoculated Investor:

*Dear Readers,*

*The following consists of my hand-typed notes from the 2010 Berkshire Hathaway Annual Meeting. These were typed in real time without the use of any recording device. As such, it is inevitable that I made some omissions and possibly even some (but hopefully very few) errors. My goal when I couldn't write down exactly what was being said was to try to capture the sentiment of the discussion. So, in many cases what is written below constitutes my impressions and interpretations. I apologize if what I took away is not exactly what others did. Also, I have highlighted some of the best Munger-isms of the meeting for people who do not have the time to go through all of the notes.*

*I have taken it upon myself to try to fill the role that Whitney Tilson occupied for many years as the official scribe of the Annual Meeting. I hope that you enjoy reading the notes. Please feel free to pass them along to anyone and everyone. If you wish to follow me and my career as an MBA at UCLA and a securities analyst, please visit my site at <http://inoculatedinvestor.blogspot.com>. Finally, if you have any questions or comments please feel free to contact me at [inoculatedinvestor@gmail.com](mailto:inoculatedinvestor@gmail.com).*

*Sincerely,  
Ben Claremon  
The Inoculated Investor*

### **Comments on 1<sup>st</sup> quarter results:**

**Buffett:** What they are seeing in their businesses: the sputtering recovery is picking up steam. The railroad business & Iscar are doing better. Things are a long way from where they were a few years ago but the trends have been stronger in the last few months. Additionally, quarterly changes in derivative values should not be paid attention to as they are not important quarter on quarter. As a rule, BRK doesn't even show quarterly EPS because undue focus on quarterly earnings is bad for managers and even worse for investors.

Warren cited a study published a few months ago where 1000s of reports examined. The report concluded that if you took EPS out 1 more decimal place (to tenths of pennies), companies were rounding up (by searching for incremental profits) earnings systematically to make the number by the penny. Warren and Charlie think of the enterprise as a whole and think about building value over time. They surely don't worry about quarterly EPS.

**Munger:** Well, I agree with you

**Question 1:** Carol Loomis- Between the 3 moderators they received between 1500 and 2000 questions. Warren and Charlie have had no hint as to what the questions will be [even though Buffett somehow how slides prepared that corresponded to some of the questions] so they will field them as they come up.

Now, onto the question. Regarding the SEC lawsuit versus Goldman Sachs (GS): Every year in the BRK movie, they use the clip from the Solomon crisis. The clip always finishes with Buffett's quote about how if people lose a shred of firms reputation he will be ruthless. Tell us the reaction to GS lawsuit and how he thinks about BRK's investment in GS. What advice would he give to GS's management team?

**Buffett:** Let's start with transaction itself. Abacus was made the subject of SEC complaint. Buffett thought there has been some misreporting (not intentional) about the transaction. This is an important subject to go through so he wanted to devote some more time than usual to it. There were 4 losers in the deal. One was GS who didn't intend to be a loser but couldn't sell a piece of the deal that eventually lost value. However, the main loser was a very large bank in Europe called ABN Amro. Why did they lose money? Because

they, in effect, guaranteed the credit of ACA. Were in the business of judging credits and in effect they fronted the transaction. In other words, they guaranteed the credit of another party. BRK does this as well and has made a lot of money doing this. But, in the 1970s BRK did lose money in similar transactions dealing with dishonest people.

In any case, 17bps were paid to ABN Amro in the form of a premium. Buffett said he was not sympathetic about a dumb bank deal. ACA was a bond insurer that started off as a municipal bond insurer like MBIA and Ambac. All of those companies started off insuring munis and this was a big business. When margins started getting squeezed they went out and started insuring structured credits (Like Mae West once said: "I was Snow White but I drifted.") outside of their expertise and all got into trouble. Is there anything wrong with insuring structured credits? No, but you better know what you are doing. When these other guys got into trouble then BRK went into the muni insurance business. They stayed away from things they didn't understand (such as CDOs & RMBS) but they did insurance similar stuff.

Specifically, here are examples of a few deals they did. One party was Nebraska Methodist Hospital who asked them to insure bonds worth \$100M. Then (when they were insuring bonds regularly) in another deal someone came to them and showed BRK a portfolio and asked BRK to insure that the bonds of certain states would pay for the next 10 years. Warren looked at the list and had to decide whether he knew enough to insure them and whether they could get high enough premiums. They collected \$160M premium and someone on the other side got insurance so if those states didn't pay then BRK was on the hook to pay. That somebody who came to BRK with the list (disclosed that it was Lehman Brothers (LEH)) with 4 distinct intentions/investment theses: (1) LEH owns the bonds (2) LEH is effectively short the bonds (3) LEH has a customer who wants protection or (4) LEH has a customer who wants to short the bonds. But, BRK doesn't care who is on the other side of the trade. All they want to do is look at the bonds and get the right premium.

Specifically, BRK doesn't care who is on the other side of the deal--Charlie Munger or Ben Bernanke. Just like BRK did with LEH, ACA took a look at the bonds and decided to insure some of the bonds from the other guy's list (John Paulson's list). They then negotiated in terms of what bonds were to be included. It was not obvious that they would all go south (in 2007) but they did in 2007 when the housing bubble blew up.

Similarly, there could be trouble in these states that BRK has insured. There could be pension problems and fiscal problems that force the states not to be able to pay. BRK could lose a lot of money but they can't go back and claim that BRK was taken advantage of. Paulson knew more about the bonds than the insurer even though ACA employs many more people. ACA made a dumb decision no matter who was on the other side of the deal (BRK or GS included). No matter what had happened BRK would not have complained and neither should the parties in the Abacus deal.

**Munger:** It's simple: this was a 3-2 decision by SEC commission when they usually act unanimously. If he had been on the SEC he would have voted with the minority.

**Buffett:** ACA was a bond insurer and not a manager. The press seems to be misrepresenting the situation by calling ACA a manager. ACA lost money because they were a bond insurer. Ironically, this whole situation has helped BRK's investment in GS. BRK got \$5B in preferred stock (that pays \$500M per year) that GS has the right to call at 110% of par and get rid of the preferred that costs them so much each year. BRK would have to put that money in ST securities if they got it back and every day that GS does not call the stock is money in the bank for BRK. In fact, it amounts to \$15 per second. Tick, tick, tick. Don't want those ticks to go away. He likes that they go on at night when he sleeps.

GS would love to get rid of the preferred. They only decided to do it because it was the height of the crisis. The Fed has likely been telling GS that they can't call the preferred and that has helped BRK. Buffett was hoping that the Fed would be quite tough when it came to allowing the preferred to be repaid. In effect, the recent developments have delayed the calling of the preferred. Now BRK will get \$500M a year rather than \$20M a year they would get from ST Treasuries. So Buffett loves the investment in GS.

There is no question that the allegation alone caused the company to lose some reputation and all the negative press has hurt the company and morale. But this is not remotely fatal or anything like that. GS had a situation with Penn Central 30 years ago and one with Ivan Boesky that hurt. But the allegation of something does not fall into the category of losing reputation. When a transgression is found out about or alleged (His motto in such situations is: get it right, get it out, get it fast, get it over) it can take a while to figure out what went wrong. He does not hold the allegation against GS. If it leads to something more serious then he will re-look at it. But, when he looks at Abacus he sees it as a legitimate transaction.

**Munger:** Agreed with all of that but said that every smart business declines business that is “proper” to accept. Standards should be not be just based on legality. Investment banks dealt in a lot of skuzzy investments and with skuzzy customers and now they are paying the price.

**Buffett:** BRK currently insures \$40B in munis. But the price is currently wrong and other underwriters are taking on more risk. BRK is going to play golf instead and wait until the price gets right again. His experience with GS goes back 44 years and they have helped BRK buy tons of businesses and have even assisted with financing. In essence they have helped build BRK. BRK trades with GS but doesn't hire the firm as an investment advisor. Warren and Charlie make their own decisions. When they trade with BRK, GS does not owe it to BRK to tell him and Charlie what they are shorting. He believes GS is rightfully acting in a non-fiduciary capacity when trading with BRK.

In general, BRK has been a part of a lot of satisfactory transactions with GS. In fact, GS helped with BRK's the very 1<sup>st</sup> bond issue Charlie and Buffet ever did in 1967. They bought a department store (Diversified Retailing) and went out to raise \$5.5M. NY Securities and Nebraska Securities [Buffett had a slide prepared that showed the cover page of the prospectus] were the underwriters. On most deals the lead underwriters are on top; except for this one. They were having so much trouble raising the money that he called GS and Kidder Peabody to ask for help when no one would give him and Charlie \$5.5M. Both companies said they would take a big piece of the deal. But they were so ashamed to be associated with the dinky little company that they asked to have their names not included. Not a lot of people were coming through for them and GS did. Accordingly, Buffett has a lot of good memories with GS.

**Question 2:** Crowd: Please provide thoughts on financial reform--specifically the good ideas and bad ideas included in the current legislation and proposals.

**Buffett:** No comments. Let Charlie handle this one.

**Munger:** “I don't think anybody knows what's going to happen.” Most Congressmen have not read the bill and everyone is in the doubt about what's going to happen. One thing is clear though: The government system that regulates the banks was so permissive and the culture so bad that it led to the stress that almost made the whole system go “blooey.” The system needs to be less permissive and people are thinking about this now. Banks don't want to lose investment flexibility. This is especially true for JP Morgan and their huge derivative book. However, so much derivative exposure may not be good for the country.

If he were the benevolent despot of the country he would make Volcker look like a “sissy.” He would reduce the activities of banks that are permitted. If you are using the government's credit to run your business then you should not have a structure so complex that the partners don't understand it. We need a new version of the Glass-Steagall Act that limits what commercial and investment banks are allowed to do. They need to be much safer businesses. Then Charlie gave an example of an S&L he was familiar with. As long as the repertoire was limited, the S&Ls were ok. But when people have unlimited credit like under the repo system, they are bound to go “plum crazy.”

**Question 3:** Becky Quick- What is the impending impact on BRK from the legislation that calls for collateral posting on all derivatives?

**Buffett:** As he understands the bill, the collateral requirement would be \$0 for BRK. If they were found to be a danger to the system by the newly created commission or the Treasury then they could be required to post collateral on old contracts. BRK has 250 contracts (while the investment banks have millions of them)

so it is hard to see them as a threat to the system. BRK only has 1% of the exposure that some other financial institutions have. If BRK is huge then these other firms are gigantic. So, there are no problems unless the commission makes more sweeping decisions that make all past contracts collateralized. In that case BRK would comply but would feel that they were owed a lot of money on other contracts. When they signed these deals, there was one price for collateralized contracts and another price for non-collateralized contracts. They offered an equity put contract recently (10 yrs) to a large investment bank with a premium of \$7.5M collateralized versus \$11M uncollateralized. Most deals were done like this so if they ever had to post collateral they would feel as though they were owed a lot of money from other of their counterparties as well.

Secretary Geithner testified to the sanctity of contracts last year and Warren feels comfortable with his stance on the issue of contracts already in existence. So, if the bill passed tomorrow then BRK would not have to pay a dime. In fact, there would be a lot of other companies who would be considered more of a threat to society than BRK. There would be a cost if they were forced to collateralize but they could use Coke stock instead of cash, for example.

**Munger:** If requirements were inserted into existing contracts it would be of dubious constitutionality. It would be like having a contract to buy a house for \$1M and the government coming in and saying you have to pay \$2M. That would be unfair and stupid and he doesn't think the government is that stupid.

**Buffett:** BRK's situation is not so different from that of IBM or other companies that have similar concerns. There are fuel and energy companies who have legitimate hedging contracts and should not be forced to send money to Wall Street as collateral. By making companies that are engaging in legitimate hedging post collateral, Congress would be forcing these companies to hand more money to Wall Street. If you pose it that way then maybe Congress will not be as excited about this reform.

**Question 4:** Crowd: Please talk about Greece, the future of the Euro and fiscal discipline in the world. Greece and other countries are clearly in trouble and BRK has investments in Europe. How is BRK positioned for currency failures? What is their advice to investors regarding the future of the Euro?

**Buffett:** BRK has a lot of exposure on the asset and liability sides in Europe. Some of the company's net worth is tied to the Euro. But their exposures are not just asset-based. BRK has liabilities that are denominated in other currencies. For example, when they reinsured Equitas they took liabilities from all over the world and invested those in US dollars. If the Euro goes down against the dollar then they benefit. So they win and lose depending on the contracts. Thus he is not concerned about the net balance on any given day and they have no dramatic exposures to other currencies. But, what we can't forget is that what happens in Greece could have an effect on the world and on the US.

**Munger:** Generally, BRK is agnostic about currencies. They just do their business. Greece is an interesting problem. What's happened in the past is that the conservatism of a place like the US has given the US a wonderful credit. It helped win WW2 and helped revive Japan and Germany after the war. It has ensured prosperity in all these decades that BRK has flourished. Now all governments have less credit and Greece is just an example of a country that pushed its credit too hard. You need credit for society to function and when you blow it, it's not a good thing. Responsible voices are now seeing the trouble in government credit; more than they have been previously.

**Buffett:** People have to distinguish between countries that borrow in their own currencies and those that borrow in other currencies. If you borrow in your own currency then all you need is a printing press-- you don't default. When you are forced to borrow in other currencies then you can default. Greece is sovereign but they can't print their own currency because they are tied to the Euro. The Euro was an interesting experiment but we may be seeing a test case play out of in a country that is not using its own currency and is sovereign. Buffett doesn't know how this movie ends. He does not like forecasting disaster--he doesn't go to movies like that. But, this will be high drama in any case. BRK does not make big currency plays and very seldom develops strong views. Having said that, the events of the past few years have made him bearish on the ability of all currencies to hold their values over time. This problem is not unique to the US or UK. If you could run 10% budget deficits indefinitely then everyone would have been doing it. But most

people understand that it can't be kept up forever. How the world weans itself off of huge deficits will be interesting to see. But, the truth is that if the US borrows in US dollars then it cannot default.

**Munger:** The public stats that countries release are misleading. Unfunded promises are much larger than government bonds outstanding. If you grow GDP at 2-3% you can afford unfunded promises. But if you get to where the growth stops you get enormous social strains and fiscal situations could get a lot worse.

**Question 5:** Andrew Ross Sorkin- Given that BRK is a GS shareholder, please give us an idea who should run GS other than Blankfein. Should GS have disclosed the Wells Notice? Has Buffett been contacted regarding the Galleon investigation?

**Buffett:** BRK has not been contacted in any way about Galleon. Buffett read about it but they are just allegations for now. Regarding the Wells Notice, Gen Re got a Wells Notice and they filed an 8-K to that effect. But, Buffett has been on the board of a company that got a Wells Notice, but they didn't publicize it and it turned out to be nothing. If it is regarded as material then it should be disclosed. But plenty of Wells Notices must not get publicized. In terms of another CEO, if Lloyd had a twin brother he would go for him. He has never thought about another GS CEO. Even in the past when certain problems came up at GS he had the same favorable opinion of the leaders at GS. Plenty of stuff that goes on with Wall Street is not right but it is not specific to GS.

**Munger:** Charlie would not have regarded the Wells Notice as material. Companies can't report every little thing that happens or it would produce way too much confusing info. There are plenty of CEOs he would like to see gone in US, but Blankfein is not one of them.

**Question 6:** Crowd: The leading cause of death among young people is car crashes. BRK insures many of these crashes. New technology is helping give people feedback on their driving. How are GEICO and the Gates Foundation positioned to help save lives and improve this technology?

**Buffett:** The Gates Foundation has a large initiative on cigarette smoking, which is probably a lot more serious than car crashes. The Gates Foundation can't solve all the problems in the world. Deaths/mile have diminished over the years as cars have become safer (not due to cell phones and Blackberries of course, technologies that are leading to more deaths). Everyone has an interest in bringing down deaths and GEICO has a large safety program. Auto companies are working to make cars safer as well.

**Munger:** Nothing to add

**Question 7:** Carol Loomis- Buffett has stated that he will attempt to keep BRK's stock price rational. But since he is giving a lot of stock to the Gates Foundation each year and they are selling stock, won't the foundation selling create downward pressure on the stock?

**Buffett:** There are 5 foundations that get money each year. The total amount of stock each year amounts to about 1.5% of shares outstanding. If the foundations sell the stock right after to make gifts then you have 1.5% shares selling each year. That's not a lot when you compare that to the daily sales on the NYSE. He never sells shares and will never sell one in his life. But only 1.5% should not move the price down in a year. By him selling down his shares it actually led to BRK having a better chance of being in the S&P 500 (as a result of the diminution of his concentrated holdings). If none of the stock had been given away there is no way to know where the stock would be--up or down--but the giveaways should not influence the stock price.

**Munger:** A stock distribution to aid charity is a non-event.

**Question 8:** Crowd-What is the biggest challenge facing US economy relative to other countries? What are the implications for investors?

**Buffett:** Buffett started off by saying that BRK did not buy BNSF to move it to China. He loves that it is in the US. He claimed that the major threat is a chemical or nuclear attack. In one year there is a small

probability but over 50 yrs the probability is very high. But, this country unleashes human potential more than any country in the world. We live differently because this system has enabled ordinary people to do great things. This game is not over-- humans can achieve a lot more. In the 1790s people had no idea of their ultimate potential and this is still true for us today. He actually hopes the rest of the world does well because it is not a zero sum game.

He would be perfectly content if BRK were forced to limit its investments in the US. He would rather have the whole world to invest in but he will not run from the US because there will be ample opportunities going forward.

**Munger:** By and large BRK has not had a global allocation system. BRK looks for things that seem sensible to them and mainly concentrate on those matters. Charlie and Warren will let the world fluctuate as it will but they are more comfortable with certain countries.

**Question 9:** Becky Quick- How did the four CIO candidates perform over the 2008-09 period? Did they use leverage?

**Buffett:** The list does not include the same 4 as previous. In any case none of them use leverage and none of them covered themselves in glory in 2008. But they did do well in 2009. The potential CIO list will move around more than the CEO position. If Buffett died tonight then in 24 hrs there would be a new CEO. But for the CIO position they could wait a few months because there no great need to do things day by day. He feels they can be leisurely with the new CIO in terms of deciding who they want to bring in and how the compensation would work. They have a list of very capable people who would like very much to manage BRK money and would do well. In terms of the CEO question, you want an answer immediately and want to be prepared the next day. But, he did just have a physical and everything is fine. His doctor can't believe he eats like he does and is ok. But in terms of BRK, they have developed a distinct culture that people will love even when he is gone.

**Munger:** One CIO candidate made 200% in 2009 with leverage of zero. Charlie is not an optimistic person but he thinks that the culture of BRK will last a long time and will outlast the founder by a long time.

**Question 10:** Crowd: Please talk about the shift to investing in capital intensive business and the ultimate impact on intrinsic value. Help us understand the time value of the necessary capital expenditures.

**Buffett:** BRK is putting big money into good businesses but they are not as good as the other companies they used to be able to buy when they were dealing with less money. See's Candy requires \$40M in capital and earns a great return. At the size BRK is now and since their job is to find great companies, they want to put money to work intelligently (but not brilliantly) and that includes capital intensive business. The world is not set up from them to re-invest \$10B at a time. But does that mean they should pay out excess capital instead? No, because they think they can earn a good return even with the need to make capital investments in certain businesses. See's is not a growing business but it's a great business. But it cannot be translatable internationally like Coke.

Buffett hopes that he doesn't disappoint shareholders in allocating money but warned that we can't expect great returns from this base at BRK.

**Munger:** Said he was good as not knowing what future returns will be as Warren is.

**Question 11:** Andrew Ross Sorkin- Why did BRK buy so many debt instruments during the crisis period as opposed to equity?

**Buffett:** Questions like this make sense now (in hindsight) but the answer was not so obvious last year. Buffett did not know what Harley Davidson's (HOG) equity was worth. But he does like a business where people tattoo the name of it on their chests. But of course he can't figure out the economic value of that. There are different risk profiles between debt and equity. He knew that HOG was not going out of business and that a 15% return was going to look very attractive. He knew enough to lend them money but not to

buy the equity. It was a simple decision about whether HOG was going to go broke or not. He didn't have to think about what was going to happen to the motorcycle industry. In general, BRK needs to have some money in stocks and some in other assets but stands ready to invest in anything that comes. They had the opportunity to put money to work when others couldn't and they took advantage.

**Munger:** After all BRK is a fiduciary for people and is not constrained to buying stocks. Generally, the question is good about debt versus equity. In distressed situations it often happens that buying the stock turns out to be better in hindsight, but there is certainly more risk.

**Question 12:** Crowd- How do you build the culture of a new organization or change that of an existing one?

**Buffett:** It is much easier to create a new culture from scratch. It is very hard to change existing cultures. At BRK it would be impossible to change the culture. Accordingly, it is much better to start from scratch than to change a culture. Buffett and BRK have had the luxury of time and have bought complementary businesses that bought into the BRK culture. If you tried to change it, people would reject it.

**Munger:** "In your position my failure rate was 100%." (Referring to changing of existing culture)

**Question 13:** Carol Loomis- Ajit Jain is very important to National Indemnity. Do you expect National Indemnity's float to rise going forward? Does it have competitive advantages beyond Ajit?

**Buffett:** Ajit's operation has advantages that go beyond Ajit, even though he uses them better than anyone else and has maximized them. The advantages do not go away if he retires. He has people who follow his practices and he has created a very disciplined operation. He cannot be replaced and it would be a huge loss if anything happened to him. But it would not hurt the BRK reinsurance operation. BRK would still be able to take action quickly and insure things that other won't or can't. Every year he thinks the float has peaked. Inevitably, some stuff runs off but additional amounts continue to get added. He was ready to quit at \$20B and now it is \$60B. BRK owns the premier insurance companies in the world but Buffett can't image how the float would increase meaningfully without huge acquisitions. Accordingly, they will not organically grow the float at BRK at a fast clip. But many things could happen though that add to the float (in terms of future deals).

**Munger:** Nothing to add. I agree with you.

**Question 14:** Crowd: Why are you not investing in India at the rate it is growing?

**Buffett:** BRK does currently have and is developing more connections there. But there have been distinct requirements that have disallowed non-Indian companies from being in the insurance business there. Buffett is going to India to see what Iscar is doing there. They are absolutely looking to expand. India is expanding rapidly and Iscar belongs there. They do not rule out India for marketable securities or direct investment. He believes that countries do learn from one another and India may be able to benefit from the experiences of other emerging nations. If you looked at China 40 years ago you wouldn't have been able to predict what has happened since. Maybe countries can learn a lot from what the US did right and actually may do better than the US. He thinks that countries can overcome problems.

The problem is that China and India do limit how much BRK can own (when it comes to insurance). Right now they would rather have their management teams work on investments in which they can own 100% of as opposed to just 25% like in India and China. But, they remain interested because people in China and India will live better 20 yrs from now.

**Munger:** The one trouble in India is that the government has paralysis and endless due process. China is going to grow faster than India because the government in China creates less paralysis. He certainly admires the democracy in India but not the paralysis.

**Question 15:** Becky Quick- Please share your current thoughts on the risk of inflation in the US.

**Buffett:** Said he has always worried about inflation. Charlie talks about how the dollar has depreciated 90% since 1930 but it has not been the end of the world for the US. He believes that the chances for significant inflation are high in the whole world. Governments have embraced things that could lead to inflation. He worries that the weaning off of the medicine may be worse than the initial illness. There is no way that countries with high deficits to GDP will not see the diminution of currency value over a period of time. If you want to bet your life on higher inflation you should bet your life on a lot higher.

**Munger:** I agree.

**Question 16:** Crowd: How can we teach people about investing and help us prevent another bout of financial mayhem?

**Buffett:** We will see financial panics from time to time and it is not a function of IQ or education. In fact, it may have more to do with prevailing conventional wisdom at business schools. The flawed ideas they have been teaching about markets have been the culprits over the last 30 years. In any case we are not going to prevent financial madness. Having said that, developing good financial habits early in life is very important. Not everyone gets that at home like he and Charlie did. The Secret Millionaires club is the new initiative to help kids learn. It's not going to change the world but it could be a plus in the lives of young people. Ben Franklin taught good financial habits years ago and now they are trying to make those habits entertaining. Good learning at the elementary level is more important than in advanced degrees. Warren's life would be very different if he had not gotten guidance during his younger years. He then discussed what he learned from a guy who ran a newspaper he worked for.

**Munger:** McDonald's (MCD) has a program that educates its employees that may be better than some universities. MCD hires marginal people early in their careers and through the training they become disciplined and educated and eventually move higher in terms of job status. Employment at MCD is underappreciated and has served this country well.

**Question 17:** Andrew Ross Sorkin- This is a question regarding Warren's taxes. Warren has stated that his assistant pays a higher tax rate than he does and that to be equitable the tax rate should be higher on him than on others. In reality, the bulk of estate will not be taxed due to his charitable donations. How do you change the system so people like Buffett pay more tax?

**Buffett:** A wealth tax is an answer. If you want to give away all of your money it is a great tax dodge. People should give away all their money like he has because the money could do a lot of good. In the US, if we spend 25% of GDP then we cannot keep taxation at 15% of GDP. Two classy people are heading up the deficit commission--Erskine Boles and Alan Simpson. They are going to have to recommend higher taxes and lower expenditures and after that they won't be popular. We won't be able to increase taxes on lower income people so it's going to be a tough equation to solve.

Take BRK shares for example: he will not ever sell a share. He has everything he needs in his life and because BRK does well he can give shares away. Some people might suggest that Warren should give money away to the federal government instead. But in reality we would not want to give that money to the federal government [implying that it would not be used efficiently].

**Munger:** Those who worry about Warren's taxes are wasting their time. Warren will have left it all when he dies.

**Question 18:** Crowd- What is going to cause the inflation that Buffett sees coming?

**Buffett:** Investors can't look at any one metric in any given month and figure out the impact on inflation. Volcker got rates up into the high teens 30 years ago and we saw what happens when people get fearful about the value of their money. If we continue what we are doing now then we are likely to see a repeat of what we saw in the 1972. But, we have the power to control our future through elected representatives. In

general though, he goes back to the conclusion that currencies are a poorer bet than they have been in a long time but he does not know what that means for the near future. Remember that your money can be inflated way but your talent cannot be inflated away. As long as you are the best at what you do you will be entitled to your portion of profits.

**Munger:** The best defense is to contribute to the world and to try to make yourself more talented.

**Question 19:** Carol Loomis- BRK has failed in letting Net Jets lose so much money. What errors were committed? What was learned and how do you prevent it from happening again?

**Buffett:** Mistakes will be made over time. Sometimes situations are extraordinary. They were buying at fictitious plane prices that were based on how much people thought they could be sold for. In the end they were not prepared for what was obviously happening and had to write down a lot of the planes. They also let operating costs get out of line with revenues. Remember that he stayed in the textiles business for 20 yrs before he finally woke up. Charlie was telling him in year 2 that it was a mistake.

They are now operating at Net Jets at a decent pretax profit and not with any boom in plane sales. They have a business plan that has no diminution of service or safety but is now more in line with revenues. David Sokol turned it around like no one could have.

**Munger:** People have to look at Net Jets in context. If he and Warren buy 30 businesses and 95% of the time it works well then it is not a bad failure record. So, they will not change the management approach at all. They will continue to trust people to manage their own companies. This is how it has worked for years.

**Question 20:** Crowd- This is a question about BYD. How do you analyze a technology company like this when for so many years you shied away from investing in tech companies?

**Buffett:** Deferred to Charlie

**Munger:** BYD is an interesting example because 5-10 yrs earlier BRK would not have made the investment. He thinks it is a sign that old men can continue to learn. BRK would have a lower potential if they had not learned. Said that in reality it was Sokol who helped get Warren to do this.

**Question 21:** Becky Quick- How does BRK structure compensation at its subsidiaries?

**Buffett:** First, they never engage a compensation consultant. They have 70+ businesses with different characteristics. There is no BRK-wide standard that would make sense (insurance operates with minus capital and BNSF has tons of required capital expenditures). The truth is that chimps could run some businesses and others are so complex that the best managers have trouble running them. They think about what is the best way to compensate people based on the individual business. It really does not take a lot of their time.

It is not rocket science, but it does require the need to differentiate between people and businesses. It requires common sense and an interaction with the managers. Everyone listens to each other to figure what people are actually adding to the company. Some managers make \$10M+ a year and some others suffer when BRK suffers. The rationale for the compensation should be understood but there is no cross-BRK rationale. You can't put a cost of capital factor like most consultants would do. It's just nonsense. They pay managers for widening the moat between BRK's businesses and the competitors. So far, he can't recall a manager who has ever left for compensation reasons.

**Munger:** The US Army has a centralized system that makes sense but BRK has a peculiar structure that works for them. It is amazing how simple it has been and how little of their time it has taken and how well it has worked. They don't want an imperial headquarters that gets hated in the field.

**Question 22:** Crowd- Managers are allowed to operate without interference with Omaha. What would happen if BRK found illegal activity? Would they intervene?

**Buffett:** Absolutely, they have to jump in. They have a hotline. Sometimes they get direct letters. He wants to hear about problems. He believes that they have an internal audit function that works for BRK. Anything that comes in that relates to bad behavior gets investigated. Every now and then some transgressions get reported and come right to Warren. He sends a letter every 2 years and asks each manager who they would select to replace them if they died that night. They won't trade reputation for money. This is why they put the Solomon video in the movie each year. If the best reason you can come up with to do something is that everyone else is doing it then that is not a good reason. He encourages people to call him if they think anything is close to the line. If something is allowed to fester then it can become a problem. There will be more issues in the future since they have 260K people working for them.

Munger: They care more about reputation than business mistakes for sure. Protecting BRK's reputation is essential. The ideal is not to make as much money as possible within the legal limits. "Wealth is only celebrated when it is fairly won and wisely used." He believes that the BRK shareholders are part of the culture as well.

**Question 23:** Andrew Ross Sorkin- In terms of the BSNF deal, you have discussed the certainty of allowable returns in the industry. How are these calculated?

Buffett: The authorities have adopted a 10.5% ROIC as the agreed upon amount. Of course this could be adjusted if there was a huge change in interest rates. He doesn't think this is a crazy standard. Railroads, unlike the electric utilities where you are guaranteed a rate of return, are more volatile due to the risk of large economic contractions. In general, you want railroads investing a lot more than depreciation to improve the transportation system. The country as a whole and the railroad systems have a common interest in not earning a huge profit but generating a fair return that allows for continued investment.

Munger: Railroads have been regulated successfully. They have been totally rebuilt over the last 30-40 years through improved tracks and train sizes. The industry has adapted well through wise regulation and wise management. This has not always been the case in the industry. But the existing system has worked well for all of us.

**Question 24:** Crowd- How is BRK ok with models used by its insurance companies after the widespread failure of models during the financial crisis? Are they different and/or safer than the ones that failed Wall Street?

**Buffett:** BRK has large exposures to earthquakes. The Chilean one will cost them. Peak risk exposures (earthquakes and hurricanes) are down considerably from a few years ago due to poor rates in those areas. If rates were attractive then they would take on these risks even if the worst case is a \$3B loss. They lost a lot in Katrina and 9/11 but are not exposed to anything that would make them uncomfortable.

BRK's willingness to take risks that others are not is a permanent advantage. They can lose \$3B and not feel any differently the next day. As long as they accept only smart premiums and don't take on risks that could destroy a lot of their capital, they will be fine. They are fine with lumpy earnings and large losses when others are not.

**Munger:** BRK is deliberately seeking risks that could provide large losses. They just want to be rich enough that one big loss won't hurt them. Their competitive advantage is that they are willing to take on that risk.

**Question 25:** Carol Loomis- What useful functions do derivatives play in the economy? Didn't we get along well without them in the past? How are naked CDS different than naked shorting?

**Buffett:** Derivatives have a role to play. BNSF hedges diesel fuel. He wouldn't do it personally but he is OK with them doing it. If you have that great ability to know where fuel costs are going then you should not even run the trains: you should just bet on fuel prices for a living. The best description of the way that capital markets function is in from Keynes: when the main enterprise becomes speculation as opposed to

legitimate business then it is problem. Keynes wrote in the 1930s about the conflicts of interest inherent in the Wall Street system. When the S&P derivative contract was first allowed to be traded it led all the speculators on Wall Street to dream up new ways to gamble as academia applauded all the way, while simultaneously claiming that there was a social purpose.

**Quote from Keynes:**

“Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done. The measure of success attained by Wall Street, regarded as an institution of which the proper social purpose is to direct new investment into the most profitable channels in terms of future yield, cannot be claimed as one of the outstanding triumphs of *laissez-faire* capitalism – which is not surprising, if I am right in thinking that the best brains of Wall Street have been in fact directed towards a different object.”

**Buffett:** It doesn't make any sense that the tax treatment on gambling on S&P 500 contracts is better (partial long term capital gains treatment) than buying and holding individual stocks for less than a year. This distortion came about as a result of the power of a small group of lobbyists.

**Munger:** Derivates are overrated. Even if we didn't have grain derivatives we would still have wheat. They do make things easier for some companies. The question is whether, on net, they are useful. The question is not whether they provide some benefit. Charlie thinks that if everything other than commodity derivatives disappeared the world would be a better place.

The idea that the tax treatment on something that is held for 3 seconds is different than something that is held for less than a year (some long term gains treatment for the former and none for the latter) is insane. Anytime a small group of people with a lot of money have that much influence it is not a good thing.

Charlie noted that Buffett wrote the only letter in 1982 saying that derivatives were dangerous and the S&P 500 derivative contract should not be allowed.

**Question 26:** Crowd- What do you think of short sellers being investigated for being publicly bearish and short selling companies? Is short selling healthy? Is a healthy discussion between bulls and bears healthy for the markets?

**Buffett:** There is nothing wrong with people who are positive or negative speaking out as long as they are responsible for what they say. You can do things on the long or short side that are unethical or illegal. Anytime you attack conventional wisdom though, you will get a lot of negative feedback. When he and Charlie criticized the EMH (Efficient Market Hypothesis), it was so widely accepted people didn't like their comments. In general he has no problem with short selling.

**Munger:** For the most part we are criticizing the wrong people (the short sellers). The people the criticisms should go to are the accountants who have not been accountable at all.

**Question 27:** Becky Quick- Please discuss some of the synergies among BRK companies and whether or not you encourage companies to do business with one another.

**Buffett:** There are 6,000 Dairy Queens (DQ) around the world. The company-operated portion is only about 70 stores so they are 99% franchised. Most franchisees serve Coke but it is entirely their business. They can sell Coke or Pepsi. Some other franchises in the US have more control over that than does DQ. DQ goes back into the 1930s and a lot of the original agreements were done on napkins.

Synergies at BRK come from the operational level. They do not tell companies to do business with each other even though they hope that they do. They think subsidiary A and subsidiary B have a good reason to do business together. The idea is that the managers are smart and can decide with whom to do business. People work better together when they want to work together. As opposed to being told to that is.

**Munger:** We really like it that way.

**Question 28:** Crowd- What qualities to do look for in a manager and how can I be your successor?

**Buffett:** “Probably shoot me.” BRK managers choose who their successors are. Buffett makes no decisions about who gets hired at GEICO or Mid American. They are responsible for their own operations. Occasionally there are deaths or resignations but those have happened only 10-12 times in 40 years. BRK is not a good employment agency. They hired one person recently in the main office and that probably will last a few years. The best people really stand out. If you think like an owner then you have very little competition at most companies and are very likely to be successful.

**Munger:** Claimed that there is no indication that they would be good at selecting successors in any case.

**Question 29:** Andrew Ross Sorkin- Buffett stated his policy about retaining earning in the 1984 annual letter. Would a distribution be warranted based on 2005-2009 stock performance?

**Buffett:** In the 2009 annual report he actually re-wrote the section from 1984. He believes that the 1984 version was poorly written. In fact, he would have flunked the test (that would have forced him to pay out a distribution) then as well as the market had recently lost money. But, the truth is that every dollar left in the business has generated \$1.30 in value. So they have met the hurdle and test from his point of view. Every time the stock market went down for 5 years they would look dumb no matter how well they allocated capital. The 1984 letter was worded poorly but it was intellectually honest based on what he intended to say. No distribution is coming because they continue to meet the test and expect (over time) for that not to change.

**Munger:** I like people to find errors and rub my nose in it.

**Question 30:** Crowd- Why doesn't BRK hire more people to give them hope?

**Buffett:** BRK will hire people when they have something for them to do. BRK is actually net hiring people right now. BNSF is carrying many more cars now than they were but the carpets business is down 6000+ people from the peak. The carpet business won't go down forever but it does not make sense to hire people when there is nothing for them to do. When he first bought Berkshire he kept the textile plants open for 20 years even when they were struggling. If you believe in capitalism and creative destruction then you need a good social safety net. Society owes people a minimum living standard, especially when people can't find work. But, BRK should not be a social safety net.

**Munger:** If BRK decided to hire people just for the sake of it, it would eventually lead to less human hope.

**Question 31:** Carol Loomis- The trend towards people owning more cars in developing countries is very clear. When it comes to car insurance business in China, India and Europe, why isn't BRK benefiting?

**Buffett:** There is certainly not a shortage of new drivers in the world. In China and India BRK can only own 24.9% of an insurance business. They have thought for decades of ways to expand GEICO because it is a great company. But they do not think that they could build the same advantages in other countries. He believes that now and for a long time to come there will be much opportunity in the US for GEICO. Other areas just do not provide the same advantages. In general with their great businesses, they do love the idea of brand extensions and product line extensions but have decided not to expand with GEICO.

**Munger:** Nothing to add.

**Question 32:** Crowd- What is the most important thing Buffett learned from Charlie? [Buffett and Munger misheard the question--perhaps because it was asked by a Chinese girl--and thought she said China as opposed to Charlie.]

**Buffett:** China is an amazing economy. Growth on a per capita basis is amazing. There were 290M people

in 1790 (and only 4M in the US) in China but for some reason for 170 yrs very little progress was made. The potential of the Chinese is now being realized. It is a sight to behold. However, they haven't taught him to eat Chinese food.

**Munger:** Munger believes that there are some very unusual people at BYD. Said that he knew from a young age that the Chinese people had an enormous potential for success. He saw that from Chinese-Americans he had dealt with but he underrated how fast the development could happen. He commented that the Chinese set a new record for advancement and that it's fun to watch.

**Question 33:** Becky Quick- The question referenced some changes made in the annual report-- look through earnings are gone and unaudited business groups are not included. Why were these made?

**Buffett:** Buffett was perplexed by the question. He pointed out that the report actually breaks down the businesses into 4 groups (answer to 2<sup>nd</sup> point). As for the first item, at some point adding 100 pages to the annual report obfuscates information as opposed to adding enlightenment. He tries to use as few words as possible to capture what is going on in the business. When it comes to look through earnings, they are not reported every year due to word constraints. Nobody has ever told him the report is too short. Every other year he may do the breakdown of operating earnings.

From the beginning his audience has been his 2 sisters. He is writing for someone who has not been involved day to day but wants to know how he is thinking about the business. They have a lot of their net worth in BRK and he actually starts "Dear Doris and Berty..."

**Munger:** Earnings from companies owned but not controlled (about 15% of reported earnings) used to be more important than they are now.

**Buffett:** Coke (KO) and American Express (AXP) don't pay out all of their earnings and everyone knows that so it's not a big deal.

**Question 34:** Crowd- Please comment on the new ROTH IRAs conversion opportunity for tax free appreciation.

**Buffett:** Pass it along to Charlie.

**Munger:** Charlie is going to convert to a ROTH IRA so he is ok with it.

**Question 35:** Andrew Ross Sorkin- Are they looking at the iPad (from Apple) and other new technologies' potential impact on newspapers? Is there an opportunity there for newspapers to benefit?

**Buffett:** Newspapers are no longer the only game in town. That's a big difference now to advertisers. It is very tempting if you have substantial circulation but the math in terms of distribution costs and printing costs just doesn't make sense. It is possible that the new technologies could help the model but he doesn't understand them and thus he stays away from them.

In Buffalo the paper was down less than Rochester and other places even though the demographics are tough. Thriving communities have papers that are dropping in circulation at rapid rates. The world has changed so much in terms of the essential nature of newspapers. In the 1970s there was nothing that looked more bulletproof than newspapers as competition melted away. But the business has lost its essential nature because people no longer go to papers to look for stock and sports news. Advertisers were there because they liked the microphone to talk to people and that is losing its appeal now. Papers are still essential to him but are clearly not for the rest of society. An advertiser does not need them the same way it needed them years ago. They now have lost pricing power. He knows that the cities are not going away but that does not mean much for the newspapers. In the past they had the discretion to charge whatever prices they wanted and that ability is now completely gone. [Buffett then told a little story about the owner of a newspaper who used to brag about being able to charge people whatever he wanted.]

**Munger:** Independent newspapers became dominant and had impregnable strength. They behaved better because they were still strong. They were the 4<sup>th</sup> state and they kept government honest. As these franchises have weakened it has been bad for the country. He believes that we are losing an institution that is important to the country and he has no idea what to do about it. Politicians are now behaving badly as newspapers have lost power. We are going to miss the newspapers.

**Question 36:** Crowd- Will there be fewer \$100 bills lying on the sidewalk going forward for investors? If that is true should he try to build a business instead of going into money management?

**Buffett:** There will always be opportunities as long as you are not running too much money. There are conflicts of interest in any businesses (right now the focus is on Wall Street). If you manage a modest amount of money then there will be the opportunity to outperform. People always make the same mistakes. There are conflicts of interest that cause people to focus on asset gathering that is not good for shareholders. Opportunities will come around: you just have to be prepared to grab when they come. You can't do that with as much money as BRK is running.

Those who take the high road are seldom held up by traffic (especially in Washington). Money management is very scalable and easy to get into. Would not have wanted to work his way to the top as a plant manager because by the time he got there he would likely have been ready to retire. So, he thinks there are probably opportunities in each area--managing money and building another business.

**Munger:** Warren always says to take the high road; it is far less crowded.

**Question 37:** Carol Loomis- Are there going to be a lot of muni bond failures? Are bond insurers going to be able to handle it?

**Buffett:** If a bond is insured by BRK there is nothing to worry about. But for other insurers there is correlation risk. It would be very hard in the end for the government to turn away a state that was having significant financial troubles, especially given what they did for General Motors (GM). They couldn't just turn away a state governor. But, there is no telling how contagious it would be. For bond insurers contagion is a problem. A lot of these entities almost failed just when they got in trouble with structured credits. It could be far worse, given their risks and already strained capital levels, if there were widespread municipal failures.

**Munger:** Investors should want to invest only in disciplined companies. It's really that simple.

**Buffett:** When other people are misbehaving or mispricing risk and companies see that, there is the impetus to do so as well. Eventually that has to come to an end though.

**Question 38:** Crowd- Is Buffett still optimistic about the US like he was when he wrote the NY Times Op-Ed piece?

**Buffett:** There have been only a few times in 30-40 years that has he declared his opinion about the market as a whole. He was actually early in 2008. He doesn't know what the market is going to do next week, next month or next year. He just thinks that he would rather own US equities than 10 or 20 year bonds. This is partly because he is very bearish on the alternatives. He believes that the alternatives are only likely to provide some modest positive real returns over time. Other than that he doesn't know anything.

**Munger:** Equities are the best of the bad lot of opportunities. People should get accustomed to doing not as well in their portfolios going forward.

**Buffett:** He likes to own full and partial businesses that are attractive and that beat holding cash.

**Question 39:** Becky Quick-Has the investment case for Moody's changed? Should BRK sell the stake completely?

**Buffett:** The rating agencies have had and, even given current circumstances, have great businesses. They have pricing power and they require no capital. Parts of the world think they needed these companies and others are mad at them. They made the same mistakes as many people made regarding the probability of nationwide housing price declines. Some part of it was poor incentives but a lot of it was based on the trouble inherent in betting against the crowd.

There is going to be a lot of backlash and maybe legal liability going forward but if they are not forced to change their model it is still a good business because they have pricing power. At BRK they have never relied on bond ratings. They don't outsource any investment decisions. In summary, they believe that if the social model doesn't change it is a great business.

**Munger:** Rating agencies in their current form have been a good influence for many decades. What happened was that their cognition faltered and they drifted with the stupidity of their time. American business education led people to believe in these stupid models. We have yet to hear an apology for the huge contribution that academia has had to our troubles.

**Question 40:** Crowd- How much of our current prosperity comes from cheap oil and how do we sustain that if oil isn't as cheap?

**Buffett:** Oil discovery changed the world in a major way. We have been sticking straws into the US since then. We have exploited what probably took millions of years to create and that has contributed in a huge way to the prosperity of the world. But he thinks the world will no longer be dependent on this windfall for the next 100 yrs. He thinks there will be new free lunches such as solar energy going forward. He said we should never underestimate the ability of humans to innovatively solve problems that look impossible to face. If you could pick a time to be born (aside from nuclear threat concern), this is the time. He believes that the transition away from fossil fuels will include a workable period of adjustment.

**Munger:** 150 yrs ago we needed oil to get ahead. Since then we have benefited from other new technologies that have helped us get ahead. It's not that horrible to contemplate a world without oil as long as it is as rich and as knowledgeable as it is now. In reality we need the oil and coal for chemical feed stocks more than for running cars and heating homes.

**Question 41:** Andrew Ross Sorkin: This question was about the Kraft- Cadbury deal. What would you say about \$26.4M compensation for the Kraft (KFT) CEO or the capital allocation decision to buy Cadbury?

**Buffett:** Odds are that both the pizza deal (KFT sold its frozen pizza business) and the Cadbury deal were dumb deals. He didn't like either of them. He and Charlie expect to do dumb things but they get mad when others do bad things with their money. The pizza deal was a terribly tax inefficient deal when they knew how to do a better deal from how they sold the Post cereals business previously. He and Charlie have done a lot of dumb things in their lives and now they are more tolerant of other people who make mistakes.

Irene (the CEO of KFT) is a capable person. If it were him he would not have bought Cadbury and would not have sold the pizza business. But, KFT is still trading at less than its component parts (especially based on what they are valuing Cadbury at). He just didn't like that they gave up so much to buy Cadbury for such a rich price. BRK has one rational compensation system and there are other people who don't (implying that KFT does not).

You will always have an army of people who have an incentive to get you to do a deal always pushing deals on you--bankers, consultants, analysts, etc--so he understands the pressures on CEOs.

**Munger:** When you have tough competitors it is easy to think that any change in your business will solve all of your problems. Most of the time it doesn't work out that well.

**Question 42:** Crowd- Has the financial and economic crisis changed the integrity of management?

**Buffett:** The "everyone else is doing it" standard is terrible. For example, corporate America fought back

when they wanted companies to expense stock options and the FASB backed off (also due to Congressional pressure). When they backed off they provided a couple of difference options for companies--to expense and not to expense. 498 of the 500 companies in the S&P chose the un-preferred way (to not expense) and only 2 chose to expense them. They decided not to do it because everyone else decided not to do it. In reality they decided not to penalize their shareholders because other companies were not. At BRK they try to create as few situations as possible for conflicts like these to arise. At BRK managers have no official budgets. So, there is very little temptation to fudge their numbers because they are not tied to specific budgets. They intentionally create a structure that minimizes the temptations for humans to cheat.

**Munger:** The crisis was precipitated by the lack of integrity of management. It is the safest way to make money (to have integrity). Integrity is terribly important. Everyone mouths the integrity even when it is lacking so it is hard to know whether it is there or not.

So much of the bad behavior does not come from greed. It comes from subconscious cognition. The best cure is a system where people who make the decisions are accountable. That is why the mortgage origination and selling of packaged securities on Wall Street was immoral. No one has really apologized for the behavior that looks so regrettable. Probably because people think they did fine. They are not even sure they did anything wrong.

**Question 43:** Carol Loomis- Given that we are not out of the woods yet in terms of the economy and the financial system, how would you assess the current buying opportunity for stocks?

**Buffett:** He has seen some times when undervaluation screamed at him and when overvaluation screamed at him. For the most part he believes that we have been somewhere in between. Right now we are somewhere in between and it is not the best time he has seen.

In terms of being scared during the depths of the market lows, if you can't handle the ups and downs and have the right temperament then you won't make much money in the investing business. People are focused on the pricing and quotes for stocks on a daily basis. But you wouldn't buy a farm and think about what it was worth on a day to day business. Ben Graham wrote about the importance of temperament years ago and everything he said still applies. Most people don't have the temperament to handle the ups and downs in the market. People who own a farm don't think that the market and the price is "telling" them something. What counts is buying a business at a great price and forgetting about it for a long time.

**Munger:** Said he developed more courage when he learned he could handle hardship. Maybe people should get their feet wet with more failure.

**Question 44:** Crowd- Is there a way to create synergies between BRK companies to promote solar solutions?

**Buffett:** I have nothing to add.

**Munger:** Munger declines to put solar panels in on his roof because he thinks they are going to get cheaper. He thinks that solar is going to be important going forward because we need it as a form of energy. We have no other practical alternative and it should be regarded as a good thing. What in hell would modern society do if we had no alternative to fossil fuels? Of the course the cities that are choking to death from toxic air are going to electric cars. Growing corn for ethanol is a stupid idea and is an example of how our politicians have failed us. Difficult technical problems are being proven to be solvable. In the end, it is not all that important if solar technology costs 2 times as much as we are used to. It will be just a blip in terms of our total prosperity. In fact, the capital expenditure to get solar up and running will be great for the country.

**Question 45:** Becky Quick- How impactful have the recent investments been on the BRK portfolio?

**Buffett:** The degree of undervaluation in the current portfolio is not dramatic and it has been exceeded many times in the past. He thinks they will do reasonably well over time. BRK has good businesses and he

and Charlie try to allocate capital rationally. BRK tries to not waste money at the top of the organization. Said he doesn't have things in the portfolio that he expects to go up dramatically in price.

**Munger:** Can't help on this one.

**Question 46:** Crowd- Can you explain your general optimism for the US even given the numerous problems we appear to be facing?

Buffett: No comments

**Munger:** Thinks that our main problems are energy related. The fact that there is a solution on the way is not a small benefit to humanity. So, Charlie is hugely optimistic for the future. He believes that the culture at BRK will continue to succeed because it works. There are terrible problems in the world (but it is much easier to get great results when your expectations get pushed down) but he takes pleasure in India's and China's potential. "I can be optimistic even when I am almost dead. You guys can deal with some inflation"

**Question 47:** Andrew Ross Sorkin- Is all of the media exposure the best use of Buffett's time from the perspective of shareholders?

**Buffett:** Probably not. He also plays 12 hrs of bridge a week and knows that's not the best use of his time for shareholders either. If you want a record of what was said he would rather be on Charlie Rose where it is permanent than in written form and being quoted by a journalist. GS CEO Blankfein would likely love to take back that quote about "doing god's work." Buffett would rather people be able to see him and read his body language when he is trying to represent what he thinks. He thinks either his writings or TV appearances are likely to be the most accurate.

**Munger:** No comment.

**Question 48:** Crowd- How does BRK attract and retain a shareholder base even though shareholders in general are so fickle?

**Buffett:** When you are running a company you can have anyone from bin Laden to the Pope owning your shares. They elect you, not vice versa. All he and Charlie can try to do is convey their message regarding what kind of place BRK is. Some see that as an invitation to come in and some see it as an invitation to stay out. You have to deliver what you promise. You can't promise everything to everyone just to attract shareholders. He and Charlie don't want to disappoint people and don't want to spend their time with people who they are likely to disappoint. They want people who think they are partners, know they will be treated like partners and think the way he and Charlie do. In the end this should lead to a stable shareholder base.

He thinks BRK is blessed not to have an IR department. It is really ridiculous that companies go out and try to cater to expectations that they can't achieve with operations and in the end have to do with accounting gimmicks. He knows that there is no way BRK share slots will remain empty so he might as well be honest and set expectations that lead them to attract people who understand what BRK is all about.

**Munger:** What happened at BRK (to create this culture) was a bit of an accident. Their first investors were family and friends. They still regard shareholders (even new ones) as family. BRK morphed into a company that bought public companies. It may not be just be about Warren and Charlie. It may have to do with how BRK came up in a different way. Then, after the culture was developed, they just stuck with their strategy.

**Question 49:** Carol Loomis- When it comes to the current zero interest rate policy (ZIRP) in the US, what is the effect?

**Buffett:** Right now it is really tough for people invested in short term instruments. If you got .1% year in and year out in a money market account and did that since Columbus landed, you might have doubled your money by now if you didn't have to pay taxes. It is very painful for people on a fixed income. He sees

purchasing power is getting eaten away. ZIRP will end at some point because it can't last. He said he would not want to be Fed Chairman or Secretary of the Treasury. It won't work forever to have easy monetary policy and fiscal deficits. When we do eventually run into trouble we should not blame the Fed but the Congress instead.

The pressure exerted by ZIRP on the value of other assets cannot be underestimated. As fear abates, there is pressure to push stock and real estate prices back up. This dynamic is understood by the people who have something to do with those matters (the Fed and the Treasury). The last year of stock price appreciation has been the at the expense of the agony of people in money market funds. The problem is that, unless people in money market funds are scared for the world, they have to put money into equities to get any yield.

**Munger:** Munger said our situation is amusingly depressing. Stocks are up because you can't earn anything on cash or on other assets. Whether that lasts or not the outcome is not going to be a cheery picture. Either we are Japan with stagnation or we get inflation.

**Question 50:** Crowd- How does Buffett get better at valuing companies?

**Buffett:** He started off not knowing anything until he learned from Ben Graham who taught him to how value a specific type of company. But, the universe of those companies dried up. Then, Charlie taught him about durable competitive advantages. The important thing is not knowing exactly where your circle of competence is, but where the perimeter is. He said that we would be surprised at how many companies he does not know anything about. The goal is to find companies that will be around for 20 years and offer a margin of safety. People have to recognize their limitations to be successful in this business.

For example, he never had any idea that Korean companies would be something he would look at. But they were so cheap and there was an opportunity to take a basket approach because they were so cheap. So, even though he didn't know each company perfectly he knew the investment would turn out well.

**Munger:** To be good at something like investing you have to keep learning because the world is changing and competitors are changing. People have to try to go to bed at night a little wiser than they were last night. People who focus on this almost never fail miserably. If you have the right temperament then you may rise slowly but you will eventually rise. Charlie said he started valuing businesses when he was a little boy. He learned that you could make money when you had no competition. A lot of Omaha businesses that were leaders when he was young either went bust or had to sell at a modest price. But people like Peter Kiewit were destined to win because they cared more than others. He would not have bet on anyone who was already wealthy. This is how life is. It is hard to reach the top and it is even harder to stay there. He thinks you can tell who is really going to be successful. If you have the right temperament you will be successful and if you don't he said he can't help you.

**Buffett:** It really is simple: avoid doing dumb things. When Charlie was practicing law he thought he knew more than just about everyone who came into his office. He was incapable of looking at businesses without evaluating the underlying fundamentals. This is essential to being a good investor.

**Question 51:** Becky Quick- What types of businesses have the highest ROIC?

**Buffett:** There are businesses like KO that you can run with no capital. How much capital is needed in a business is one way to define the attractiveness of the business. Many companies operate with negative capital--magazine businesses are like this. People make a lot of money in magazines. Businesses in which you get the float ahead of time are great. Apple doesn't need much capital. It is smart to bet on companies that can get large while needing little capital--See's Candy is an example. But, there is no way to get people to eat 10 lbs of candy each day.

Consumer businesses usually need little capital. In businesses where people pay you in advance (insurance and magazines, for example) you are using the customers' capital. BRK likes these businesses but so do other people so it gets competitive. Also, service businesses like BusinessWire need very little capital and have been very successful

**Munger:** Nothing to add. He likes businesses with pricing power and monopolistic characteristics.

**Question 52:** Crowd- When it comes to growth at BRK, what is the current acquisition appetite and outlook? Has the phone been ringing?

**Buffett:** The phone does not ring much at BRK. They have said they want larger deals so that weeds out a lot of phone calls. If they get a couple of serious phone calls a year where the company fits their criteria-- then it is a good year. But, they are as interested as ever. They wrote a big check and issued shares for the BNSF deal. He would love it if the phone rang and a good deal was suddenly on the table.

**Munger:** It is amazing how successful they have been at buying desirable companies. Human revulsion has helped them. The people they buy from don't want to sell to big companies who will try to control them. This is very peculiar as they have a screening device that other acquirers don't enjoy.

**Buffett:** Iscar said that they wanted to sell to BRK or no one. Another company had 3 options-- sell to a competitor (where it would probably would have been worth more), sell as an LBO (where the company would be a piece of meat to be re-sold), or sell to BRK (because they were the only player left). This scenario plays out all the time but it is somewhat accidental. People want to monetize their business, often so they can give away money. BRK is a logical and ready buyer in a lot of deals but they can't accelerate this process in any way.

**Munger:** The acquisition pace will be slower than in other years. This is a good thing because they are richer now. But there will still be acquisitions going forward.

**Question 53:** Andrew Ross Sorkin [Question from Peter Brotchie] There are a lot of questions Warren and Charlie do not get asked. So, what questions would they ask themselves regarding BRK's financials?

**Buffett:** Can you keep using all the capital you generate effectively for a long time? There comes a point where the numbers get big enough that it becomes very hard to move the needle with capital allocation. It is hard to create more than \$1 for each \$1 invested. He thinks that BRK can go further now than he would have thought 30 yrs ago but there is a limit. There will come a time when they cannot intelligently use the amount of capital they accumulate and at that point they will do what's best for BRK shareholders.

**Munger:** There is not a lot to say about things that need to be done differently at BRK. It is interesting that they got into BYD even though it is a type of tech company that they had talked about avoiding in the past. He thinks it is because they have learned and that the BYD investment is likely to work out very well. BYD can help solve significant problems of the world and shareholders should take pride in that. He feels the same way about BYD as he did about Peter Kiewit. He and Warren have found a way to invest in their own kind, except these people are better. He said he would not have been good at venture capital.

BYD has already accomplished things that seemed impossible to do but they have done them. He does not think this is the last thing that BRK does that will seem a bit unusual. In terms of the BNSF deal, he knew it was better for their shareholders but it was also good for BRK shareholders. So, who cares who does better? He likes the fact that a lot of engineers are being added to BRK.

Also, he thinks that they will find people at BRK on the investing side that are almost as good as Warren. Some of these people may even have what Warren lacks. So, it won't be all negative when Warren is not around.

**Question 54:** Crowd- What advice do you give to young entrepreneurs?

**Buffett:** Buffet said to follow your passion and love what you do. BRK has all types of managers. The common factor is that they love what they do. People have to find that in life. It was dumb luck that Warren's dad was in the securities business. If you find something that turns you on then you are likely to be successful. There isn't actually that much competition. There are not likely to be people running as fast

as you.

Some BRK managers didn't even go to high school. Ms. B (Rose Blumkin) never went to school in her life. She started with \$500 in capital and now Nebraska Furniture Mart is the largest furniture store in the country. People who love what they do have incredible potential. Mrs. B. had a power within her that was unique.

**Munger:** No comments.

**Question 55:** Carol Loomis- What is the reason he and Charlie do things so differently than other people? Is there a unifying theory at BRK for management and life?

**Buffett:** Passed it along to Charlie.

**Munger:** "It's pragmatism." He said that they do things this way because it suits them and their temperament. They also found out that it works better. He said that it's just that simple and that they have had the good sense to keep doing things that work well. Repeat what works. "Is that terse enough for you?"

**Question 56:** Crowd- Does the US need a high speed rail service. If so, should it be private or public?

**Buffett:** High speed rail is probably non-economic when it competes with auto or air. The US doesn't have the point to point density or the demand that would produce the return on capital necessary. All of the times he has seen projections regarding the economics, it just doesn't work that well. Unless it is heavily subsidized, it won't pass the test of private economics. If it is high speed it by definition can't stop much or spur off too much.

As an example, they are talking in Omaha about building a trolley system. The revenue projections are so low in relation to the total costs that the math just doesn't work for these things. If you can get the money from the government some people think that it doesn't cost anything. But it really does. They did it in Buffalo and it probably would have been cheaper to give everyone a cab ride for the cost of the public transportation. But of course people like it. The US is just too big. It could happen from US government money but from not money that wants a return.

**Munger:** Said he doesn't know much about the economics but he was dubious. The cost of putting in a new system in an already populated area is unbelievably costly. It works well in Japan and China but putting it in LA looks like a pit of money that could never be recouped.

**Question 57:** If there was an earthquake the size of the recent Chilean earthquake in LA or San Francisco (SF), what would be the damage and impact?

**Buffett:** The level on the Richter scale is not a perfect predictor of how costly earthquakes can be. The big damage in SF (in the 1906 quake) came from the fires that raged after the quake. \$100B would probably be the highest amount. The frequency of such disasters is minimal but you have the potential for a VERY high severity rate on the Richter Scale. He tends to think that the worst case quake exposure is probably around \$100B. BRK is totally prepared to handle anything that comes along, even if it is worse than he expects. Even in a \$250B worst case loss, BRK would still likely have positive earnings. "We are prepared..."

The Chilean losses have also been coming largely from the tsunami and not all the quake. In any case BRK is in a different class than other insurers. BRK has so many other operating businesses that generate earnings. So, while other companies would likely be gasping, they would be fine.

**Munger:** The more recent California quakes have not caused much fire. Munger told us to remember that a lot of quake damage is not insured. Quake insurance is not universal like fire insurance. Plus, wind and fire conditions are often worse than quakes.

**Question 58:** Crowd- The gross overuse of credit led to the financial meltdown. Now we see a huge

increase in debt across the world. What would BRK's exposure be in another global financial meltdown?

**Buffett:** A total meltdown could be problematic but Buffett made the bet in 2008 that the government would stand in front of a complete collapse. He believes that the government would go all in again. If there was a nuclear or chemical attack that wiped out a substantial portion of the population, then there is no telling what would happen. In any case, BRK would likely survive better than just about any other company. The US government now has the experience and tools to put in measures to prevent a complete collapse and would likely do it again.

When things are bad in one area they get bad in others. But huge amounts of debt are not going to do BRK in. No matter how silly governments or other companies get with their financials it is not going to harm BRK.

**Munger:** "I'm not worried about it."