

UCLA Anderson School of Management & USC Marshall School of Business

Q&A with Warren Buffett

**Berkshire Hathaway Corporate Headquarters
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Mr. Warren Buffett is an energetic and charismatic man with a great sense of humor. He loves what he does and has a unique ability to absorb large amounts of information and condense it into a simple point of view.

DISCLAIMER: Only the words in bold italics are direct quotes. Everything else is paraphrased.

Question: Can you comment on Alan Greenspan's recent remarks regarding the reversal of asset values that typically occurs after prolonged periods of sustained low volatility?

- Greenspan is correct.
- There has been a compression of credit spreads. I bought billions of junk bonds a few years ago.
- Things could get real bad should interest rates continue to rise.
- ***"Wall street swings in huge manners."*** It will make you all rich if you can keep a level head and make rational, educated decisions.

Question: What advice can you give MBA students entering the field of investment management?

- First of all, investment management is a great field, if you like it, it won't feel like work. It is a field where you can get paid extraordinarily well.
- Have passion for what you do and where you work.
- Work for someone you admire. ***"I found my passion working with Ben Graham. When I first went into his office, I told him 'I'll work for free'. Graham promptly replied 'you are still overpriced'."***
- ***"For me, the money was not that important. The starting salary was not that important."***
- ***"Alternatively, if you like investing on your own, just start digging. Dig into companies, turn pages and wait for something to jump out at you. Research, research, research"***
- ***"Nobody is going to tell you about the great ideas"***
- Mr. Buffett started with Western Insurance Securities. He found his opportunity in the 1951 Moody's Banks & Finance manual. Great western insurance was trading at \$3-\$13 a year but was worth \$20 at Book Value.
- Even if you are working for a company, invest on your own no matter how small your capital.
- Build your knowledge base because knowledge is cumulative. Had Mr. Buffett not researched insurance companies, he would not have been ready or willing to make the investments.
- Ideas should come from what make sense to you, not from what you read or from what someone else tells you. Act on what you learn yourself.
- ***"Grade yourself on your temperament."*** Temperament is the ability to not be swayed by the market. See what you are supposed to see.
- Before making an investment decision, take out a notebook and without looking at the price of a company write ***"I am buying X shares in this company for Y price because..."*** The only reason to buy a company (or shares in a company) is that it is worth a lot more than it is selling for. You then do your homework to find the "range" of prices that the stock is worth.
- Investing is a "positive sum game": if you rule out all the bad moves you're going to win.
- It is almost impossible to come to an exact value for a company.

Question: How do you keep such a level head and perspective? How does bridge and exercise help you maintain this perspective?

- Being in Omaha helps. Not having Wall Street whispering 20 ideas a day into my head.
- I like to act on what I know. Things that make sense jump out at me.
- Ideas should come from what you know and have learned. Exercise and Bridge keep my head clear and sharp.
- For example, during the market bubble, the market capitalization was at 170% of GDP, with real earnings contributing to 6% of GDP. That equates to a market multiple of 30. At other times, you have seen the

market trading at 70% of GDP, "you do the math."

Question: What do you think of white collar crime and the penalties given out recently? Also what advice can you give about staying out of trouble in this respect?

- **"The people who have been convicted of these crimes are getting what they deserve. But it is not a perfect justice system by a long shot."**
- On how to stay out of trouble, Mr. Buffett recalled a story he heard about a man on death row reading The Bible for the first time. When asked what he was doing, the man responded "I am trying to find loop holes." Relating to a code of ethics for companies that are hundreds of pages long, there will always be loop holes.
- **"Judge every action as if a smart and slightly unfriendly reporter was writing an article about it on the front page."**
- **"There is plenty of money to be made in the center of the court."** If you feel like [the morality of the business decision] is not clear, it is probably wrong. When it is right, you don't question it. Mr Buffett referred to his managers coming to him with moral ambiguity: if they are calling me it is probably wrong - they don't call if things are morally right.

Question: Our generation is dealing with pension and social security issues, what problems do you see our children and our children's children facing?

- From a non-economic point of view, terrorism has escalated to an entirely new level and will be with us for a while. I did some math on probability of terrorist event. 10% per year over next 50 years equates to 99% probability. 1% over next 50 years is something like 40% probable.
- Economically, we consume 6% more than we produce. I feel that a lingering issue will be the trade deficit. We consume foreign goods in exchange for paper—be it bonds or stocks—and that is going to come back to haunt us someday. There will be political consequences.
- The United States has a flat tax rate, once you account for income tax, payroll tax, strategic tax planning, etc. This has "happened without anyone knowing it."

Question: What role government should have in Economy/Business?

- There is definitely a role for government but it is a tight rope that must be walked carefully. For instance, when China (CNOOC) comes in and wants to buy Unocal, and the government disallowed the acquisition; that is getting to a questionable point (I realize the national security issues, but it doesn't seem right).
- **"A pure market system does not work."**

Question: It has been stated over and over again that the U.S. Stock Market will be facing a single digit return environment. As a result, investors are looking elsewhere to get their desired returns. What are your views on this issue?

- Single digit returns aren't all that bad. Occasionally the barometer in the stock market gets ahead of itself. It has been running a "little rich" lately. It's crazy to think you are going to be able to earn consistently 10% when global GDP is at 5%.
- We want to be producing things that China is consuming.
- Greenspan sent me a 1901 NYT article; Greenspan mentioned that the paper cost one cent in 1901 and now costs one dollar. Greenspan joked that that's only a 4% CAGR in price!
- We are living seven times better than we were 100 years ago.

Question: If we use the "Margin of Safety" criterion so often touted by Ben Graham and Warren Buffett, is there a danger of becoming by-standers as no worthwhile investments come our way even after long waiting periods?

- Margin of Safety is the untapped pricing power in a business.
- In an investment management job, if you must pick companies to invest in, pick those that although fully valued, are still excellent companies with strong business models.
- Pick companies with enduring competitive advantage:
 - i.e.,: See's Candy and Borsheims jewelry. Items that carry an emotional value.
 - When you don't care about a product, it's a commodity.
- Management that will do a good job:
 - Love the business not the money.
 - You must be able to read people.

- Buffett skips to work each day because the outcome is not known.
- He often makes decisions with out firm (hard) numbers but with firm knowledge of a good margin for safety.
- Mr. Buffett gave an excellent example of the concept of Margin of Safety. He asked if any of us would consider driving a truck weighing 9800 lbs over a bridge that can withstand a max of 10000 lbs. Of course, the resounding answer was NO. Nobody wants to take a risk of that nature. The designer of the bridge could have made slight errors when calculating the max weight capacity. Further, the bridge might not be as strong today as it once was. So, only drive a truck that is well below 10000 lbs.

Question: In a speech you made several years ago to a group of college students you stated that "there might be more to be gained by studying business failures rather than studying business successes." Can you please give an example of a recent failure and share what you believe is the lesson to be learned from this example?

- Companies must have enduring economics—competitive advantage—and management you admire and trust. I ask myself, of management, "Do they love the money or do they love the business?" I do not try to lock in management with employment contracts at Berkshire. I try to spot the extremes and deal with high probabilities.
- Most of my mistakes have come from omission or not investing in companies that I should have in industries that I know (e.g. companies within his circle of competence: Wal-Mart). I do not count the tech bubble because I don't understand it that well.
- Don't dwell on your mistakes too long because things always change and the next problem will be a little different—e.g. Dexter Shoe's (underestimate changing industry dynamics).
- Take action on what you can figure out yourself, and swing big. Usually other people won't be swinging.

Question: How do you view India and China as possible investments?

- We want China as a market. China is an economy that is working well.
- In 1790, there were 4 million people in the US. At the same time, China had a population of 250 million. They are just now realizing a business model that works for them and are unleashing power that the US recognized over 200 years ago.
- Mr. Buffett views the 8% GDP growth as real and sustainable in China.
- Berkshire Hathaway invested in Petro China because it was cheap, not because it was "China."
- Berkshire Hathaway will continue to look at investments in China but will discount them and pay less because of the risks and uncertainty involved.

Question: Forbes recently listed America's 400 wealthiest individuals, and while reviewing the bio's I noticed a fairly high divorce rate. Can you discuss the challenges of balancing an ambitious work ethic and a healthy life at home?

- Times have definitely changed. It used to be that the man brought home the check and the wife was expected to take care of the home and understand. Now both spouses work on many occasions and this is an extremely demanding field.
- **"You cannot maximize two variables in any equation."** You must have an understanding spouse that recognizes what makes you happy and is supportive of your decisions.
- **The most important part of all is children—the first five years of a child's life are the most important. You cannot relive these years, which are the most developmental years of a child's life. Never use sarcasm with a child.**
- **They will remember if you let them down. I have never been let down and that is a large part of what has made me so successful.**
- I plan to give my children enough money **"so they can do anything but not so much that they can do nothing."** Each of the children has a foundation set up that I give money to. My daughter is active in an organization that provides help to underprivileged children. They start working with the kids when they are very young to try to give them all the opportunities that more wealthy children get early in life.

Question: Role of Hedge Funds

- A hedge fund is nothing more than a change in compensation. There is no magical secret they have, in fact Ben Graham actually started the first one in 1924 even though he is not credited for it.
- Large institutional investors have developed unrealistic market return expectations. These investors do not want to change their expectations, and so have pursued alternative investment vehicles. With 7% returns, a 2% management fee is a large fee. Hedge funds will disappoint investors over the next few years.

Question: If you were to start a holding company today, and had capital constraints similar to those you had when you began your career, what would your strategy be? How would it differ from your previous strategy with Berkshire Hathaway and why?

- You want to make big decisions, not many decisions.
- If you had a punch card for your life and you could make only 20 decisions, you are bound to be successful because each one you make you will have a high conviction for.
- If I had \$10 million (or \$1 million) to invest I would crush the S&P; I'd look to beat it by at least 10% per year; with \$10 billion, I will seek by it.
- Cull the universe for small companies and apply basic filters
- Would buy small companies; would screen certain criteria like EV/Sales and others looking for cheap companies that adhere to other criteria (Interest Expense to Earnings and EBIT).
- Concerning my venture in Korea; I invested *my* money (a relatively small amount). I found numerous companies trading at two times their earnings. Examples: Posco (PKX) is the most profitable steel company in the world and earns \$4 billion after tax. Daihan Flower Mills is another good example.
- REITS are relatively overpriced now, but were a good value in 1991 when they were "not sexy."

Question: Which value investors in today's world remind you of your earlier investing days?

- I do not operate from NY, so I am not very aware of the current crop of value investors; amongst my peers, there are a few people like former students of Ben Graham, who exhibit the same style of investing.

Question: Do you think it is a problem with the U.S. Economy that so few non-for-profit universities have been founded in the last 50 years?

- Not really a problem; the U.S. university system is very strong.
- **"I was fortunate growing up in Omaha when I did"** – the world was not equal – I was taught by very sharp women who weren't allowed to have careers.
- I am grateful for the terrific public school education I got in Omaha. It was very beneficial having great teachers—most of whom were women because there were so few other jobs for them at the time. Now that there are more career opportunities for women, fewer talented women are going into teaching.
- I am more worried about preschool and elementary education. We need to make it more economically equal.

Question: What do you consider to be the concerns of next generation?

- 100th anniversary of $E=MC^2$. 1945 unleashed the power to harm great numbers of people in a single instance, unlike conventional arms dating back hundreds of years beginning with throwing stones, the musket, the cannon, etc.
- Knowledge of how to create nuclear, chemical, and biological Weapons of Mass Destruction (WMDs) is now available. Material availability is the bottleneck and must be controlled.
- Some say that eradicating poverty is the solution to the threat of WMD's. That is wrong. Only rich nations have used nukes. The only way to prevent a major terror event is to control the supply of WMDs.
- Leo Szilard drafted letter for Einstein to Roosevelt warning about the power of nuclear energy. Hitler luckily did not obtain it first because he persecuted the Jews: Einstein was a German Jew.
- Economically, the country will do great. The current account deficit may cause disruptions and "cataclysmic" markets from time to time. Transfer of ownership is not infinite, and political issues will arise as a result.
- When dislocations happen, markets do weird things, and there is a lot of money to be made.

Question: Given the sharp growth in the real estate market, what do you see happening in the hot markets such as Los Angeles and San Francisco over the next few years?

- There will be a correction in the market.
- I do not blame the people for buying expensive houses because creative loans were too attractive.
- I expect there to be a considerable decline in the prices over the next few years (a 10% or greater decline would be very possible).
- REITs are generally overpriced.
- Inflation could make the situation much worse.

Question: What are your views on Healthcare Reform?

- Spending is 14% of GDP, or roughly 2-times as a percentage of GDP of other developed countries.
- Must "ration" healthcare. Historically, supply of healthcare has been rationed by income. This is difficult to

do by government in a "rich democracy." ***"But I wouldn't want to be the guy to do it."***

- The challenge is separating services that could be universal from services like critical care. The last period of life support consumes the majority of health care costs. This leaves a predicament that has serious political ramifications: how do you choose who lives longer and who doesn't? Currently the system favors the wealthy who can afford the best life support systems, but there is too much political risk to "ration" the system. Who will do it?
- The natural competitive market is low cost with no loss in quality. US companies will have to compete on low cost and will therefore need low cost structures (implying health care benefit costs must either be stabilized or reduced).

Fun facts:

- Would love to own Traders Joe's or In-N-Out Burger. Would prefer Trader Joe's and will give a finder's fee to whoever brings him the deal. Once wrote a letter to owner of In-n-Out and never got a response. Doesn't write many letters; wants people to come to him with deals.
- Loves chocolate covered cherries and gingerbread cookies from Trader Joe's.
- Has a Gold McDonalds card and a Johnny Rockets card that lets him and 3 guests eat for free.
- Is a St. Louis Cardinals fan; attended the playoff game vs. Padres the day before.
- Likes Nebraska football but thought Texas Tech would win the game, albeit by a smaller margin than last year.
- Ordered a Cherry Coke and Hot Beef open faced sandwich for lunch (at Gorat's Steak House).
- Drives a silver Lincoln Town Car; license plates read "THRIFTY."

Jokes/Quotes:

- Comment on the "Ovarian Lottery" – We were lucky to be born as humans; I could have been some small furry animal in a Darwinian world.
"Don't eat me! I can allocate capital"
"Great! Those are the ones that taste the best"
- Reference the Peter Lynch quote of not building a business that a dummy can't run because at some point one will!
(Jab at the US presidency in saying it's not like we've always had "first draft picks")
- Warren: "Mirror, mirror on the wall, how much should I charge for candy this fall?"
Mirror: "More, Warren More!!"
- This is from the Mr. Bob Batt, EVP of Nebraska Furniture Mart – "Taking a business lesson from Warren is like taking a Physics lesson from Einstein"