

Transcript for Wharton Warren Buffett Meeting February 17th, 2006

These are based on (multiple) notes and so are incomplete and we take full responsibility if they partially misrepresent the nuance of what Mr Buffett said.

1) You have proven to be exceptional at identifying and selecting talent – people that run companies you acquire and retain, people you bring in to work for Berkshire. Many have said that managing high performance individuals – especially innovators – is a challenging task. What is your advice for us as future managers of companies? How do you get such high performance from your managers?

First, two things to note

- 1) I get to paint my own painting, this is a terrific luxury in life.
- 2) I like applause, I like my painting being out there.”

So with respect to managers/entrepreneurs, I look them in the eye and ask, do they love the money or love the business? If they love the business, then if they are NOT jumping out of bed (to go to work) it’s my fault. So I have to give them two things, which are ability to paint their own painting, and applause. The applause will come from me, and I think they see it as intelligent applause, because I know their business. If that works for me, why won’t it work for other people. Most people I buy businesses from are independently wealthy. I need them to look me in the eye and say whether they love the money or the business. I have zero contracts – the manager needs to have a better answer to say to his wife when he gets out of bed at 630am and she says “why do you get up just to send money to Omaha.” I want a rational compensation scheme – not options on Berkshire stock [which is not driven by their performance].

I have caddied for Tiger Woods. I try to find the Tiger Woodses of their industry.

The most important things about work are to do something you love, and hire/work with people you like. It just doesn’t work if you don’t admire or trust them. I do not hire people I would not want as friends or as neighbors. I work with people who make my life easier. You can’t work with people who make your stomach grind.

2) Are there any recent books you have read that you would like to recommend?

Non-Business Book

Katharine Graham’s Personal History

“This is a book that is disgustingly true, about one of the most interesting lives.”

Graham is a woman who is brilliant, but was told by her mother and husband that she was no good, and therefore had very low self confidence but succeeded through sheer perseverance. Graham did such a wonderful job that I would not attempt to write an autobiography because I could not match Graham.

Business Books

Intelligent Investor by Benjamin Graham (unrelated to Katharine)

You can't miss if you have the frame Graham provides.

- 1) A stock is a piece of a business, if you don't want to own the business don't buy the stock – analyze the business
- 2) The market is there to serve you not to instruct
- 3) Know your Margin of Safety with every investment

Poor Charlie's Almanac by Charlie Munger

“Charlie is ungodly smart about business and human behavior. He observes a lot.”

Where are the Customer's Yachts – an entertaining wise book

3) What drives your passion for investing?

I find investing a fascinating game. It is the ultimate game because so many people want to play.

I think to some extent I have an investing gene. I was very lucky in getting this gene at this time and this place – the greatest American society. Having the investing gene wouldn't do much good if I were in Africa running from lions, screaming “I allocate capital!”

Mrs B [who started Nebraska Furniture Mart] was born with a business gene but she had to get over here from Russia. Her 5 year old eldest daughter taught her mother English words she had learned at school. Mrs B saved \$500 over 16 years (she sent back \$50 each time she had that to bring relatives over from Russia). She went to the American Furniture Mart and was in awe. She copied the name and bought \$2000 of merchandise, which she sold from her own home. Nebraska Furniture Mart now turns over \$350m of business. She could not read or write – she made a mark on our contract. She competed against department stores who tried to sue her. She represented herself in court and said, “I buy carpets for \$2 and sell it for \$3. They sell it for \$5. Tell me, how much do you want me to steal from my customers.” The judge ordered some carpets from her.

You've got something in you when you do something like Ms. B did. It's not just a high I.Q. We have a number of managers who dropped out of high school.

Ms. B never spent much time at home – she was always at the store. She never had many people over, but I visited her on occasion. She had green price tags hanging from all of her furniture in her house because, it made her feel at home.

Tiger Woods hits 500 practice balls a day. He never hits one without having a specific target in mind – which part of the green he wants it to land on. You can't do that if you are only doing it for the money.

I like investing, just like I like bridge. I play 12 hours a week of bridge, and that is important to me. Having a boat and 5 houses would be a nightmare.

4) What do you think of the growing gap between the rich and the poor in the U.S. and what are the obligations of the wealthy in society?

Put yourself in the situation where twenty four hours before you were born, a genie comes along and asks you to design the world into which you are going to be born – the social rules, the political rules, etc.

The catch is that you have to go to a barrel of six billion tickets, and pick one at random. The ticket identifies who you will be when you enter this world, rich or poor, black or white, retarded or bright, male or female.

Given the “randomness” of who you are born as, what kind of world would you want to design?

You would want a *Bountiful World* - one with no system that stifled capacity or production, a lot to go round. You would want a system that worked like an Olympic trial, where Jack Welch gets to run GE and Mike Tyson gets to fight. We’ve done well there. Equality of opportunity is important. You want a modified free market that turns out what people want.

Once you have got that (and you need to get there first but we have), then you want a *Just Society* – one that takes care of people who have got lousy tickets. We have fewer jobs for people with IQs of 80 or 90. The job profile has changed but the population has not.

Now imagine that you could grab 100 tickets from the barrel and choose the best of these. Less than 5 would say the US. Of these half would be a different sex. Half would be below average intelligence. Would any of you go back to that theoretical barrel and pick out 100 tickets at random, and then pick your choice from those 100 tickets? Did any of you males peek at your ticket when setting policy? Any whites peek? You are in the luckiest 1% (at least).

There should not be unnecessary fear in a rich society – that’s why social security is such a good idea. You could not do that 100 years ago. The time was right in the 1930s.

The US had a system that unleashed people’s potential. That’s why we’re rich. China is now catching up.

In 1790 a person with an IQ of 90 could have held 90% of the jobs – there was lots of opportunity for people with mildly unlucky tickets. We have the same bell curve now, it’s just that the jobs profile has changed.

5) What do you think of the new literature on “fundamental indexation,” (including Joel Greenblatt’s books) where stocks are weighted by some fundamental, such as dividends or valuation, instead of by market capitalization?

I agree with Joel’s basic idea of buying good companies cheap. If people with IQs of 140 didn’t get off track thinking about standard deviations and betas []. Joel is writing for an audience that wants a mechanism. You can do much better if you understand businesses. If you don’t understand businesses, that mechanism is better than CNBC. For example, if you’re a dentist, you don’t want to have to think too much about your investments. Joel diversifies so that you can take the occasional crook or loss. Everyone in this room has the potential to do what Greenblatt is getting at through examination of companies – i.e. do they have a good business, able management, fair price. This is what I do. It’s a good book.

6) What further standards or regulations would you like to see FASB or the SEC put in place in order to discourage/prevent misleading financial reporting?

Publicity caused the excesses of the 90s to get wrung out. We need 3 public hangings a year of the worst guys (from a list of 50). There have been some hangings! CEOs in the 90s drifted: if people everyone admires are doing it, why shouldn’t I? The press has had a bigger effect on corporate behavior than laws.

In the last 10 years, we’ve seen chicanery as bad as we’ll see for a while. It’s not fashionable to be crooked anymore. In the 1990’s, perhaps it was more acceptable.

Jury trials are capricious but knowing they are out there and that you may be splashed on the business pages is important.

I often describe boards as elephant bumping. If you are bumping up against other important people, you must be doing something important. Pointing out that they are doing a lousy job embarrasses elephants!

7) What is the proper time period to evaluate an investment manager? For example Oakmark has been recommended by many value gurus yet it has only returned 8.4% in the last 10 years.

I would not evaluate any manager solely by the numbers. You want to know how they did it. That’s not easy. If you saw 20 people who beat the S&P by 300bps for 8 years I would rule out 18 of them. There are lots of ways to play with phasing. It’s like a duck on a pond in the rain – he thinks he’s going up in the world, but it’s just raining. You can’t blame the duck though. It’s often done because in this phase of the market your style produces results. I have found very few people (but some) who can change style.

In 1969 I closed my partnership, and thought what should I do with my clients? I was 25, looked 19, and had the emotional maturity of a 9 year old. I was mailing the money

back, and didn't know what to say. I recommended municipals and two money managers to the partners: Bill Ruane's Sequoia fund and Sandy [Gaddison].

I left because I didn't like the market. Bill set up an office for people who didn't have enough money to interest Sandy. For the first few years the performance was terrible but there were no questions in my mind.

Take LTCM. I knew the people and they had the highest IQ office in the world. But they had too much reliance on statistical methods. They used extreme leverage, which worked for every day except one day.

8) You like hard questions. Would you please share with us the hardest, absolutely the hardest question you got asked. Would you please share with us the hardest question you have asked, too?

When I meet with companies, at the end, I always ask, "If you were going away for ten years and could only buy one stock of your competitors, which one would it be? And if you could short one, which one would it be?" This is a silver bullet question. I would also always ask, "If our roles were reversed, what questions would you ask me if I were running your business?"

The most important question I asked was asking my wife to marry me. Fortunately, I got the right answer. You are changed most by your interactions with your spouse. Who your spouse is hugely affects your life and some people make mistakes.

9) As you think about the next 100-500 years, what are some of the largest socio/macro-economic changes that you foresee? (Do you have faith in the continued dominance/importance of the US as a political/economic force?)

The trade deficit/current accounts deficit is the biggest problem. We may end up changing our promises on Medicare debt. The government has an asset of a royalty on your income. The government owns 35% of Berkshire income. The government got \$3bn from Berkshire. They have a class AA stock – they take out the cash whereas we reinvest. Their stock is better than my stock. Imagine that the government sets up a special purpose company – "Berkshire Tax Corp" – what would the value of that be? Would it be more or less than regular Berkshire? The AA stock can also change the percentage that it gets. Back in World War II it owned 91%. If the US stock market is worth \$[16-17]T, what is the government bit worth?

I worry about the trade deficit. We are sending \$2bn of IOUs to the rest of the world every day. We are like a rich family that spends 6% more than it earns and so it keeps selling a bit of the farm. These claims will be entitled to a bit of our production. It is dangerous for our generation to impose this on the younger one. Go back to the American revolution – imagine if Franklin had given 4% of GDP to the UK. It sounds like a good deal but eventually it would cause political instability and would be renegotiated. We're building ourselves into that position.

Now the rest of the world owns \$[3]T. That's OK but compounding sets in. Net investment income will turn negative. This is the number one problem in our society, apart from weapons of mass destruction. It suffers from the policy cycle being much longer than the electoral cycle. We're getting vendor financing

We need to ration advanced medical care that extends a life for a few months. These are tough questions for a rich society. Medicines will get better and longevity will get stretched. How much will you pay to extend a life from 92 to 93? There will be a struggle between people in their productive years and people in retirement. We see this with the AARP.

The most important question for the world is how we live with the spread of knowledge about nuclear and biological weapons. We will always have some percentage of megalomaniacs in our population but in the old days the worst that they could do was throw a rock. Now they can do so much more damage. Hitler ran a country but drove out his best scientists because he was so anti-Semitic. The V2 rockets that targeted Britain would have left a different world if their warheads were worth anything.

Now we have millions of people in the world who are nuts (it's the same percentage) and the question is, what is the limiting factor on how much damage they can do? Knowledge is a limiting factor as is material. You will always have intent. More people today have the knowledge. There will be an attack sooner or later. It is more likely in the biological field than the nuclear. We are lucky with smallpox in that there are only two places in the world that have the culture. It's perfect for air travel as it has a seven day incubation.

The sniper in Washington D.C.: 2 people killing 1 to 2 people a day paralyzed Washington.

My foundation exists to solve big problems that don't have a natural constituency. This would be top of my list of dollars could solve it.

Solving poverty is not the answer. The richest country in the world used nuclear weapons. [Based on Buffett's father's reminiscences from his experience in Congress during WWII] No-one in Congress had any worries about incinerating 200,000 people. They felt that they had reason to do it. We have people all over the world who are thinking that in a twisted way. I was on Strategic Air Command advisor (they just wanted you to lobby for more money). We were ready to launch. It's an attitude of "use them or lose them".

On Iran, you cannot have 25 countries having highly enriched uranium or such countries with dictators and clerics without, over decades and decades, something happening. I know because I work in insurance. McNamara in the Fog of War shows the real chance of war. Russia would have launched from Cuba.

10) If you had to give \$1 billion to charity by the end of the year, to what cause would you donate, and how would you decide?

I give 125-150mm a year away to charity each year. I have a 1:45 minute video and a letter instructing my 6 trustees, who are mostly women – watch out fellows! I give them principles not specific instructions.

One principle is to address very important societal problems that do not have a constituency - ideas that are politically unpopular. For example, John Rockefeller supported black colleges, something no one wanted to touch. They had no wealthy alumni so Rockefeller said, “I’ll be the alumni”. That is the kind of thing I like.

Doing the unpopular thing means you’re going to fail a lot of the time. I want the foundation to do things with a high risk of failure – the opposite of how I approach business. I expect that because I want them to tackle the toughest problems. My thesis is that their judgment above ground is better than mine six feet under!

I would like them to support reducing the probability of nuclear/chemical/biological attack but I don’t know how to spend money there and on reproductive freedom for women. This does not have a big constituency as most foundations won’t touch it. I also believe in adoption. You can do a lot of good in the area of reproductive freedom with money. I don’t want women condemned to 20 years’ involuntary motherhood - men sure as hell aren’t.

My foundation is not allowed to do small things. If they hand out checks for \$1m here and \$1m there, I’m going to come and haunt them.

11) You have said in the past that Berkshire is always preparing for something cataclysmic. How so?

Charlie and I are pretty good at thinking about worst case analysis. I have studied eleven times when things went really wrong financially. We think in terms of the stock market closing for several days or months. We run Berkshire not to depend on anyone else.

LTCM was selling on the run treasuries and buying off the run. When the spread increased by 10bps, they thought it would converge. It did except that in September 1998 the spread hit 30bps, which defied any logic. Berkshire went in but not with an amount of money that would get us into trouble. It was a once in a lifetime situation but the issue is that anything times zero is zero.

If you’re smart, you don’t need leverage. If you’re dumb, you have no business using it. We get money from our insurance float but that has no covenants. We worry about cataclysmic events as an insurer. We write super catastrophe insurance for the gulf coast. Was 2004 an outlier with 3 [big] storms? In 2005 there were 4 more plus some category 5s that did not hit land. Has the world changed? Maybe the water is warmer. We’re willing to lose \$6bn in any one catastrophe at Berkshire. We write bigger risks

(explicitly) that anyone else in the world. State Farm [sort of does] because it can't reinsure but we take on the risk voluntarily. We work on the basis of the stock market closing for 6 months because of 3 nukes in Manhattan. We want to be there in those circumstances. We don't depend on anyone else. We have our own liquidity.

12) You talk about buying \$1 for 10c, but why don't you sell if the price reaches \$1.50 – What is the right time to sell?

For the first 30 years, I had enough ideas that I would sell a dollar at 60c because I could buy another one at 40c. That's not the case anymore. Now we only sell if the business has changed or we don't trust management. I would not manage \$150m like this.

When I got out of school in 1951, I went through Moody's almanac. On p1440 there was a company with 1949 EPS of 21.66, 1950 EPS of 29.09 and a price of \$13-[30]. This catches your eye. I got the reports, I spoke to agents and there was nothing wrong with the company. The back pages are best – I should have started there.

These opportunities are hard to find in America. But in Korea I found 20 stocks trading at 2-4x earnings. These were strong in basic industries. No-one talked about them because there was not enough liquidity so not enough fees. These stocks had tripled before I bought them. And there was an fx upside because Korea has a good current account situation. I would not have put half my net worth in them as I don't know them as well as western securities. [Buffett also took a diversified portfolio to mitigate company specific risk.]

12) What are your thoughts about Jim Cramer? His stock decisions move the market 5% or more. Does he embody Mr Market? I've heard him be in love with a stock and within a few weeks he hates it and sells it.

If I get a good idea a year, I am lucky. I cannot have an opinion on every stock every day. The market is a psychotic, drunk, manic depressive selling 4,000 companies every day. In one year, the high will double the low. These businesses are no more volatile than a farm or an apartment block [whose values do not swing so wildly]. If you buy a farm, you look to the farm to determine the value of your interest, not to some guy coming by giving you a quote everyday.

Investment is the best game in the world because you only need to find 1 so the deck is stacked in your favor. I couldn't do what Cramer is doing. He is more entertainment than anything else and he is very good at it. I'd like to meet Cramer's wife, who is a trading goddess.

13) How many years' history do you consider when you research a company?

By now I know the companies in my universe, which gets smaller and smaller [as Berkshire gets bigger]. I have annual reports for GM back to 1941 so I don't need to

