

# NOTES ON THE WESCO FINANCIAL ANNUAL MEETING

May 6, 2009, Pasadena, California

The meeting was called to order promptly at 2:00 p.m. and carried on at a leisurely pace until adjournment at 2:04 p.m. The question-and-answer session then commenced. However, in a style he later characterized as “Socratic solitaire,” Charlie Munger both asked and answered the first several questions.

## SOCRATIC SOLITAIRE

*How serious is the present mess?*

“Deadly serious.” “You can’t tell what happens when people get disappointed enough of a dysfunctional civilization.” The Depression led to Hitler. The government has been right to react vigorously.

*What caused the mess?*

It was an example of a lolapalooza effect: the result of a confluence of causes acting in the same direction.

- Abusive practices in consumer credit, namely extending credit to people who couldn’t handle it, knowing they couldn’t handle it. Sometimes you have to resist sinking to the level of your competitors. But fomenting bad practices often becomes its own punishment. “If you do things that are immoral and stupid, there’s likely to be a whirlwind” that sweeps you away.
- The “scum of the earth” in mortgage credit who “rejoiced in rooking” their borrowers.
- “We had Wall Street go crazy,” pursuing any way of earning money short of armed robbery. In Merrill Lynch’s last purchase of a mortgage outfit, they knowingly bought “a bunch of sleazy crooks,” thinking that if it makes money, who cares that they’re crooks.
- Poor regulation and legislation. Some of the legislators genuinely thought they were being pro-social in helping poor people buy houses, but they weren’t; you need sound credit just as you need sound engineering. Some of the problem was Democrats pushing Fannie and Freddie to lend, some of it was “Republicans who overdosed on Ayn Rand” and thought unrestrained free enterprise was as good for the finance industry as for the restaurant industry.
- The repo system of credit allowed this: “one of the best ways to create excess credit ever invented.”

Credit default swaps that let you profit if someone else fails are a terrible idea; in buying life insurance, you’re wisely required to have an insurable interest. Mark-to-model accounting on derivatives let both sides show a profit; “the accounting was phoney because all the customers wanted it phoney.” But Charlie’s never met an accountant who’s ashamed of his profession. People like Greenspan made what was going on respectable by endorsing it, but “it isn’t like free enterprise in restaurants”—more like legalized armed robbery. In the end, “We had to save a lot of these people whether we liked it or not.” To nationalize Fannie and Freddie and then lower interest rates so good borrowers could buy houses was “very smart government.”

In the old days, regulators kept silent about banks until they had to act, then announced a fait accompli; “put me down as dubious” about the public stress-testing. Charlie probably won’t like what Wells Fargo is made to do. Warren and Charlie think more highly of Wells Fargo than others do because of their low cost of funds. Charlie’s willing to put up with less than perfection from the government; on the whole, “it’s working out fairly well,” and “a lot of it has been done beautifully.”

*What are the long-term consequences for Wesco?*

“Practically none.” Wesco’s holdings will go back up, and indeed some of them have already gone back up quite a bit. Its businesses will take advantage of the recession, Carnegie-style, to strengthen their positions.

*What has the government done wrong?*

- Ethanol is stupid. The use of fossil water and loss of topsoil isn’t accounted for, you barely get out more energy than you put in, and driving up the cost of food for the poor is “monstrously stupid.” But ethanol appears to be waning.
- Cap-and-trade is an “insane idea.” The Chinese aren’t going to decrease their emissions. But cap-and-trade might fade away too. What we should worry about is using up hydrocarbons too fast; they have uses, as in fertilizer manufacture, where we have no substitutes. Solar is the way to go; we don’t want everybody, North Korea included, having atomic power plants. Solar, a smart grid, and battery cars. Charlie thinks solar will come down in cost by 50%, but it’s worth switching even if it doesn’t; he agrees

with Freeman Dyson that somewhat increasing the cost of energy wouldn't be a big deal. "We should listen more to Freeman Dyson and less to Al Gore"; one knows how to think and the other doesn't.

China stands to gain from solar too; they're choking on the emissions from the brown coal their power plants burn. Israel gets half its water from desalination driven by electricity. Cheap power could benefit the Arab nations too, and decrease tensions. "To me these are just ABC. Every bright high-school student in the room should be nodding his head. . . but I'm not sure that's the effect."

We could handle a rise in sea level; look at Holland. "Nervous Nellies" see trouble ahead, but we should see plenty. We do need to override obstructive local governments to get the smart grid built. We need more of the Chinese approach. One of India's problems is that it has too much due process.

*How fast will improvement come?*

Japan went all-out with stimulus and lowered interest rates to zero, yet they got stasis instead of a return to 4% growth. That would be terrible in this country, where there's less social cohesion. "Japan is a very interesting and threatening example," but Charlie doesn't know how our case will play out. Japan wasted much of its stimulus filling every pothole three times and leveling every street. We should build that smart grid.

Here's Charlie talking economics, never having taken an economics class in his life. "I'm not apologizing," and not impressed with academic economics.

*What about stock prices?*

Charlie's agnostic on what they'll do but would be willing to buy at current prices. Coca-Cola is worth what it's selling for, and so is Wells Fargo. He wouldn't expect miracles from them, but it's generally a bad idea to expect miracles anyway. If you wait for a bottom, it's often too late to buy by the time you know you've seen it. Charlie's pretty fully invested himself. This might be a mistake, but that's his thinking, and "you're entitled to know, because you're cultists."

*What kind of reregulation should come to the financial industry?*

An investment bank that is too big to fail shouldn't be allowed to be anything but a fairly boring business, making markets, underwriting offerings, and so on. It used to be that way. Partners didn't make much money. They were conservative people, they actually owned the business, and they'd seen the Thirties. It's "crazy" to let bright young men buy what they want in the repo market with enormous leverage. Gambling on high leverage ought to be banned. We don't need options exchanges or credit default swaps. A man doesn't deserve high pay for ballooning a balance sheet at a tiny spread. "Any idiot could do it. In fact, many have." We don't need a world where large numbers of very bright people are trying to get rich by outsmarting each other. Charlie admires Obama for saying he'll reduce the power of New York, but isn't sure he'll have the guts to do as much as Charlie would like done. It's "not pretty" to make your money by being a better card player than other people, whom you lure into the game.

*Buying Berkshire vs. buying Wesco?*

"As always," Berkshire is a better buy at current prices. Wesco gets bid up "because you people are cultists," but if Charlie were buying today, he'd buy Berkshire. Berkshire is becoming a bigger and better known thing all the time; Wesco is just a byway, and it's only an independent company by accident.

## PRESS QUESTIONS

*(Harper's Magazine) If you were Secretary of the Treasury?*

"They've been doing pretty well." Paulson deserves credit, as do the current Secretary and Summers. They're very able and will do a good job, though constrained by politics: sometimes you know what should be done but can't do it for political reasons. Considering what they are facing, Treasury has done a good job.

*(Motley Fool) If you were Obama, what would you incent?*

Charlie would *reduce* the incentives to go to Wall Street. He'd the markets *less* deep and liquid, *more* inefficient. He'd promote the smart grid and do away with the ability of every state and hamlet to block it. He'd promote electric cars. As for Detroit, it's an "example of a problem where, if you argued for the solution that had a chance of working, they'd bat you over the head and remove you." Toyota has tough challenges; what hope is there for Detroit? Wringing out everything through bankruptcy and emerging with a single domestic company would have a 40% chance of working. What they're actually doing has 0% chance except by constantly adding money. It wouldn't be the end of the world if domestic auto manufacturing died

out. It happened in England. Rochester used to prosper on the strength of Xerox and Kodak, and Buffalo has dwindled but is still a pretty nice place. This sort of change, some falling while others rise, is natural. “If someone my age can cheerfully die,” we can put up with the declining communities.

*(Kathy Kristof) Many individual investors are disillusioned, seeing both Wall Street and Main Street business as corrupt, and have sworn off stocks. Are they right to feel that way?*

Individuals should maximize their Social Security benefit. That isn't going away. After that, to expect a lot from stocks, bonds, or whatever is sort of irrational. The best way to achieve felicity is to aim low. Warren's standard advice, low-cost index funds, is perfectly good for most people, and certainly better than trusting the average stockbroker. (The stockbrokers in the room are different, but “they're not normal.”) It's in the nature of markets to go down sometimes. Some people in this room can earn twice the normal return, and Charlie has himself, but he can't teach everyone how to.

*(Gurufocus.com) How do we avoid losses like last year's? Or can we?*

It can't be done. “If you aren't suffering a little right now, you haven't lived a life that's right.”

*(Paul Larson, Morningstar) Book recommendations?*

*Outliers*, by Malcolm Gladwell. “There's a reason it's a bestseller.” “I tend not to read self-help investment books. It's kind of like soap operas: I figure I know all the plots.”

## FLOOR QUESTIONS

*How to hedge against inflation?*

Charlie can remember the 2-cent stamp, the 40-cent-per-hour minimum wage replacing the 25-cent wage. Inflation didn't ruin the investment climate over his lifetime. When the mass of people can vote, you have to expect inflation. It was a miracle that we had no inflation from 1860 to 1910. *But is Berkshire shorting Treasuries or buying TIPS?* Berkshire is “aware” that inflation is “the way of the world,” and we do what we can. But we bought a lot of utility bonds paying 9 and 10%. That's not good if you have inflation, but it's better than government bonds paying 3%. We don't have a one-size-fits-all solution.

*How can Berkshire invest in Goldman Sachs while inveighing against Wall Street behavior and excessive executive compensation?*

The merits outweighed the defects.

*What effect will problems in commercial real estate have on GE Capital?*

“They will lose some money.”

*Is Dell and Kent seem much more successful at Coca-Cola than their immediate predecessors, yet it's the same company. Why?*

The current CEO is “exceptionally gifted.” You can expect good results when a gifted CEO runs a good company.

*What will the business model look like for banks like Wells Fargo going forward?*

They're well situated and have bright prospects. More regulation wouldn't be a surprise.

*Can one teach executive leadership?*

Some people are more teachable than others, just as some dogs are. Capitalism keeps filtering out the people who don't do well and replacing them with people who do better.

*What qualities do you look for in a leader?*

Trustworthiness; good judgment. Warren's right that an IQ of 130 is enough (though Berkshire wouldn't be nearly what it is today if Warren's own IQ was 130). Overreaching is the problem, and is encouraged by salesmen.

*How do the long-term prospects for the investment climates in India and China compare?*

If you're asking whether Wang Chuanfu of BYD will do well, he'll do “amazingly well.”

*Why is growth emphasized? Are there limits to growth?*

Yes, of course. The material world is finite.

*Berkshire's invested a lot in railroads, but freight volumes are down, and a smart grid with solar and wind would be bad for coal hauling. What would change your views on railroads?*

Burlington Northern would still be hauling freight. Railroads have competitive advantages over trucks. They look pretty foolproof; they'd be more foolproof if there isn't a shift away from coal.

*How long would it take to design a smart grid?*

Charlie doesn't know. We'll need regulatory streamlining to get it built, but it's perfectly doable.

*(Whitney Tilson) Newspaper reports made the Berkshire meeting sound like a gloom-fest, and I wondered whether I'd been at the same meeting. How do you see opportunities today and their effects five years ahead?*

Sure we have opportunities, and a smart grid would be good for Berkshire. The guys running Berkshire's utility business are very good; for one thing, they get along with regulators by giving them what they'd want if they were regulators. There's "considerable opportunity" for Berkshire to be bigger in utilities.

*Human misjudgment?*

Like sunshine, it will always be part of the world. At Berkshire, there's less of it than elsewhere, and this provides an advantage. The best chapter in *Outliers* is the one about the guy with the 200 IQ who was a total failure in life.

*Will there be oil to meet demand in the next five years?*

We're near peak oil, whether the peak is just behind or just ahead. On the other hand, there's a lot of new gas, and that's surprised everybody. The world will adapt to whatever the price of oil is, "because it has to." Oil at \$200 a barrel wouldn't crater America. We'd change our ways and adapt.

*What questions are you asking yourself? What should we be worrying about?*

There are bad things to worry about. If Charlie were asked the odds of atomic weapons being used in the next 30 years, he'd put them "pretty high." But you work on things you can change, and "suck up your gut" about the rest. Japan is still a decent place despite 0% growth, though it might not work out the same here; being monoethnic helps them.

*What do you think about insuring, or buying, municipal bonds?*

Charlie doesn't want Berkshire insuring an endless amount of municipal bonds. A lot of politicians might yield to the temptation to throw their troubles on some insurer instead of on their taxpayers.

*It sounded, at the Berkshire meeting, as though \$100 million per year on advertising was maintenance cap-ex for GEICO, and the other \$700 million on advertising should be thought of as growth cap-ex. Is that right?*

Yes.

*Have you read Snowball?*

Yes. It's an interesting book, covering a life in such detail. By and large it's reasonably accurate, though any book that thick will have errors. And she made a lot of money.

*What do you think of reverse mortgages?*

They make sense, but they involve big commissions and dealing with frail old people, so Charlie is leery of them, as of anything sold on high commission to the old.

*Berkshire's an example, in some ways like a university without walls. Could we someday have documentation of decision processes released, even if long after the fact?*

Berkshire's example hasn't had much influence. Charlie compared it to a surgeon he knew of who did a very difficult procedure. Other surgeons admired him but didn't dare imitate him. Charlie likes Ben Franklin's idea of not paying government officeholders and would like to see it extended to corporate directors. A fee of \$250 thousand is a lot of money to, say, an university professor, and he's going to do what it takes to stay on the board, and try to get on more boards. But university trustees serve without pay, and directing a public company is a similar public service. "You can argue that Walmart is more important than Harvard" in its cultural and economic impact. Being a director is interesting; why should you need to pay?

*Will the coming inflation be like that of the Seventies?*

Inflation coming is a good bet, but there's not necessarily a good way to bet on it. TIPS have drawbacks. Real estate can drop in price, as we've seen. Keep your expectations reasonable.

Charlie told the story of a man who owned his house clear and had \$1 million invested, letting him live in his house on the dividends. His broker talked him into selling puts on Silicon Valley bubble stocks. He lost his money and his house and took a restaurant job, all from trying to get more when he already had enough.

*When will deflation stop and inflation start?*

Omaha had no real estate boom and hasn't had a bust; if you want a house in Omaha now, buy it. Every market is different. Pasadena real estate is expensive, but it's a well run city, and if Charlie wanted a house in Pasadena for his family to live in, he'd probably buy. "Now, I might buy it at foreclosure. . . ."

*Why did China cease to lead in science 500 years ago?*

A dumb, self-satisfied emperor and Confucian bureaucrats "like French Literature at Yale."

*Do you see something special about China?*

Charlie likes Confucian values, especially the respect for elderly males. They have a strong work ethic. They're family-minded. When Wang Chuanfu needed \$300 thousand to start BYD, a cousin provided it to him. (That was the best investment the cousin ever made.) Their leaders are engineers: "That's my kind of Communist."

*Is AIG still underpricing risk? Will the disruption in insurance create opportunities for Berkshire?*

Scandal has been bad for AIG's business. They've been "very unlucky." They'll survive but have a difficult hand to play. It could happen to Berkshire, or anybody else, if they make dumb decisions.

*What's the future of finance education, giving recent overwhelming evidence that diversification, for example, doesn't work?*

Charlie doesn't think much of finance professors. Some of them try to turn finance into physics, but it can't be done. He can't tell you how to get a good academic finance education.

*How can an individual shareholder, who can't meet management, judge trustworthiness?*

There's no one answer. If you go to Mass. General and say you want to learn to read bone-tumor slides well, they can't teach you. "No one's any good at it who hasn't been doing it for eight years."

*Are corporate lawyers' fees too high?*

Yes. On the other hand, if you can get into a good law school, you're surrounded by bright people, half from the opposite sex. It's a good place to meet a mate. And lots of people go to law school without intending to practice. But law in big firms has been too prosperous. Charlie has a lawyer friend who suggested that his firm cull one customer per year, on principle. Charlie thinks it's a good idea, but the friend's colleagues shot it down. Charlie's big early success in business was firing lots of his customers, the ones who didn't want to let the firm make any money.

*What's the future of the two newspapers you own?*

The ordinary daily paper will perish or perhaps become something like public broadcasting, subsidized by one or two big backers.

*What do you think about California tax-free bonds?*

We have a crazy legislature, gerrymandered to contain only "certified nuts" from the left and the right who naturally hate each other. Charlie doesn't know how it will play out. You can't assume good will win. Sometimes evil wins.

*Warren has said a weak dollar isn't enough to resolve the U.S. trade deficit. How might it resolve?*

Sometimes the completely unexpected happens. Who could have foreseen Margaret Thatcher and her sweeping changes after 20 years of Labour? "Warren is more pessimistic than I am." Warren thinks China will tire of sending us goods in exchange for bits of paper. Charlie thinks China is gaining enormously, and the loss of purchasing power on their bits of paper is a small price to pay. The gains don't show up in the equations of economists, but that means the equations are wrong. Getting good at manufacturing is a form of wealth.