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The 2005 Berkshire Hathaway Annual Meeting Top 20 Questions

During the question and answer portion of the 2005 Berkshire Hathaway annual meeting, shareholders asked Warren Buffett and Charlie Munger a total of 46 questions. Many of these questions were quite good, although some were more pertinent to investors than others. In order to focus on the most relevant questions and answers, we have selected 20 for closer review. Although we've billed this article as "The Top 20 Questions," we don't presume to judge the questions per se, or the answers. We simply selected the questions and answers that we thought to be the most helpful for individual investors. In addition, although Buffett and Munger need no clarification, we thought it would be useful for some readers if we supplemented Buffett and Munger's answers with some elaborating comments. The ground rules at the Berkshire annual meeting included a ban on recording devices, so the following material is based on our handwritten notes taken during approximately five hours of questions and answers. Where we feel sufficiently confident about Buffett or Munger's exact words, we have used quotation marks — although it is possible that their exact wording varied from our notes. Where we have paraphrased Buffett or Munger, we have tried to remain close to their wording and faithful to their intent. Nevertheless, please note that neither Buffett nor Munger has reviewed or endorsed our summaries of their remarks or our comments.

What are the qualities of a good manager?

A shareholder from London asked Buffett what he thought were the three most important criteria in selecting [business] managers. Buffett replied, "A passion for their business." Berkshire "monetizes a lifetime of work" for founders of acquired companies, so Berkshire wants to know, "Do they love the money or do they love the business?" Once managers have sold and become quite wealthy, their passion for the business will be the only reason they need to work, and Berkshire does everything possible to avoid dampening that passion. Later in his answer, Buffett said that he looks for "intelligence, energy and integrity," adding, "If you don't have the last, the first two will kill you." Munger commented that given "how well our system [of selecting managers] has worked over the decades, it's amazing how few have copied it."

> Comment: We agree with Buffett and Munger's assessment of the most important qualities of corporate managers, although passion and integrity are not easy for most investors to identify. In assessing these subjective qualities,

> investors should focus on Buffett's question, "Do they love the money, or do they love the business?" One realistic approach would be to look closely at a manager's compensation and stock holdings. We're pleased when corporate managers accumulate wealth ***along with their shareholders***—that is, when the value of their stock holdings appreciates in the marketplace over the long term. On the other hand, when managers collect large salaries yet don't see fit to own much of their companies' shares (other than indirectly through stock options that were given to them), it's a clue that they love the money more than the business. Investors would be wise to question the commitment of executives whose idea of stock ownership is exercising stock options and selling their stock. Where's the passion in that?

Can Berkshire compete with hedge funds for investments?

A shareholder from Bonn, Germany asked how Berkshire is positioned to compete with hedge funds and private equity firms in making investments. Buffett replied that this was a great question. He said there is "no doubt that there are far more dollars looking at deals than five years ago," and that competing investors are looking at "good, but mundane, deals." Although Buffett noted that the situation may have eased somewhat in the last 4 – 5 weeks, he said, "People are lined up to buy almost anything, and we can't compete in this [environment] … but it won't go on forever." Buffett believes that Berkshire is not positioned favorably in the near term [to compete with hedge funds], but "things can change fast." He said there had been at least three times in his career when it looked like there was "so much money sloshing around" that he couldn't compete. He ended his investment partnership in 1969 for that reason, but within four years there were incredible investment opportunities. Another instance he cited was the aftermath of the 1998 Long Term Capital Management [LTCM] hedge fund fiasco, when people were "paralyzed." For example, at that time there was an unusually wide—30 basis point—difference between the yield of "on-the-run" [recently issued] 30-year government bonds and "off-the-run" 29½ -year bonds. [Note: It makes little sense for the yields on 30-year and 29½-year government bonds to differ to this degree—thus confirming the disarray to which Buffett referred.] Buffett noted that despite "all the high IQ people in the financial world," in 2002 investors could have purchased junk bonds with yields to maturity of 25% – 65% and sold these same bonds at a 5% – 7% yield basis only 12 – 15 months later. [Buffett showed a chart of specific examples.] He noted that Berkshire bought about $7 billion in junk bonds when they were very favorably priced.

Munger commented that "a lot of buying by private equity funds is fee motivated," and this buying has driven some asset classes to a historically high basis [valuation]. He added that if there's nothing attractive to invest in, "sending dollars back [to investors] is the right thing to do, but it isn't very normal." Buffett interjected that an individual "whose name you'd recognize" called him concerning a potential investment in the reinsurance industry—a business that person did not understand. The caller would have been required to return money to his investors if he didn't invest it within a certain time period, and he didn't want to lose his two percent fee. Buffett commented that unlike many hedge fund managers, "Charlie and I have full participation in the downside [of Berkshire's investments] as well as the upside." He said that he had seen nothing among recent deals that he would have wanted to buy. Munger added that he didn't think the businesses that sold to Berkshire would have wanted to sell to a hedge fund or private equity at any price.

> Comment: Buffett and Munger covered a lot of ground in answering this question. Hedge funds and private equity managers have become driving forces (not always for the best) in some sectors of the financial markets. One such sector is convertible securities, which normally trade at a premium to their conversion values. For example, a convertible bond typically commands a price greater than the value of the stock it is convertible into, due to bonds' precedence in bankruptcy and the fact that bonds normally offer higher yields than stocks. According to published reports, hedge fund managers have purchased fully 75% of all convertible securities, and in so doing, have driven many convertible bond premiums remarkably high. Put differently, the large sums of hedge fund money pursuing "convertible arbitrage" have pushed convertible premiums to the point of dramatically reducing whatever appeal this strategy once had. Indeed, at current prices many convertible securities look like losing propositions and, not surprisingly, the Dow Jones Convertible Arbitrage index has performed rather poorly in recent months.
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> We'd also like to highlight Buffett's jab at "high IQ" types. Buffett and Munger have consistently told investors that a very high IQ is not necessary for investment success—that certain qualities of temperament are more important. In 2002, the high IQ types scorned dirt-cheap junk bonds (then yielding 25% - 65%), only to buy them a year or so later at much higher prices (and lower yields). Part of the allure of hedge funds has been the rocket scientist reputations of some of their managers. However, as the LTCM hedge fund demonstrated, academic credentials (and IQ) don't necessarily guarantee investment success. (LTCM was advised, in part, by two Nobel Prize winning economists, and the story of its stunning demise is chronicled in Roger Lowenstein's book, *When Genius Failed*, which we've reviewed at www.jvbruni.com/Bookreviews4.htm.)
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> Finally, Buffett and Munger warn against managers who are willing to make mundane (or worse) investments rather than return money to investors, and they implicitly caution investors to be careful when investment managers don't proportionately share their clients' risks. For example, it's not uncommon for hedge fund managers to earn one percent (sometimes two) of the assets they manage ***plus*** 20% of the fund's gains. To illustrate what disproportionate risk/reward arrangements can do, let's suppose that a hedge fund manager chooses mediocre, but volatile, investments. Suppose further that the hedge fund makes a round trip over a two-year period—appreciating from $100 million to $150 million in the first year, and then falling back to $100 million in the second year. In the first year, the hedge fund manager will

earn about $1.25 million in fees, plus $10 million more—20% of gains. Then in the second year, the hedge fund manager will earn another $1.25 million in fees. Can you see the problem? The manager earned $12.5 million over the two years (averaging about ***five percent*** annually of assets managed), even though the fund averaged a zero rate of return over the two-year period. Investors should think twice when managers take a significant portion of gains but don't pay back when there are losses. Generally, we'd be happier if all investment managers invested their own money *pari passu* (on the same basis) with their clients. Further, we wish more managers would eat their own investment cooking, as Buffett and Munger do. Investors might be surprised—even shocked—at how some managers' personal portfolios differ from the funds they manage.

Will commodities prices squeeze profit margins?

An attendee from North Carolina asked whether increasing commodities prices will squeeze corporate profit margins. Buffett replied that since carpet prices lag petroleum prices, for example, [rising oil prices] have affected Berkshire's carpet business. Higher natural gas prices have also affected some Berkshire companies, such as Johns Manville and Acme [Brick]; however, "over time businesses with strong competitive positions can pass through material costs, just as they pass through labor costs." Indeed, Buffett commented that high materials costs are more of "a tax on consumers" than on corporations. Interestingly, corporate profits as a percentage of GDP are now at an all-time high, and this percentage will probably decline over the next 4 – 5 years. Buffett said that the present is a very favorable period for profit margins, and there may be some reversion to the mean. He also noted that corporate taxes as a percentage of all taxes are near an all-time low. According to Munger, it's hard—yet important—to know which businesses can pass through costs. Buffett added that Berkshire looks for "untapped pricing power" in the companies it buys. When Berkshire bought See's Candies, he and Munger talked about whether sales "would fall off a cliff" if they raised prices 10¢ a pound. They saw pricing power in See's—and raised prices. Buffett: "It's not a good business when you have to have a prayer session before raising your prices a penny." As an example, Buffett mentioned the newspaper business, in which publishers used to think "rate increases were a yawn." That was when newspapers were the only means merchants had to reach consumers. Now, however, newspaper publishers "agonize" over rate increases, both in advertising and circulation. Buffett: "You can learn a lot about the durability of a business by observing pricing behavior."

Comment: It is important for investors to understand that based on logic and history, corporate profits are unlikely to continue growing faster than GDP. Therefore, regardless of the rate of inflation, aggregate corporate profitability will, sooner or later, temporarily grow more slowly than GDP—perhaps for a few years. Call us skeptics, but we suspect that one reason why corporate profits have grown faster than GDP in recent years is that some corporate income statements don't reflect all economic costs of production. For example, some companies may not depreciate assets as fast as they should—thus understating costs and overstating earnings. If we're right about this, expect to see more asset write-downs as corporate managers eventually face economic reality.

Inflation can be regarded as an economic stress factor. Inflationary stress affects companies like the flu affects people—the strong overcome the stress, while the weak face more serious consequences. Buffett is a master at coining a memorable phrase, and his remark about price increases and prayer sessions is a gem. After all, a company without pricing power—like an airline—has it tough.

Will there be a Berkshire dividend?

A shareholder from Boulder, Colorado asked about the chances of Berkshire declaring a dividend. Buffett replied that although dividends are lightly taxed now, even if there were no taxes on dividends Berkshire would have the same dividend policy. The issue is whether Berkshire retaining cash will create more shareholder wealth, in present value terms, than distributing the cash. If not, "We should distribute it all." He added that "the burden of proof will certainly shift in a few years if we can't do anything." In that case, "We should pay out very substantial sums." So far, however, Buffett said that every dollar retained by Berkshire has produced more than a dollar of market value. He said that the subject of dividends would be discussed at the upcoming board of directors meeting [two days after the shareholder meeting].

Comment: As Buffett said, the dividend decision—for all corporations—should be straightforward. Either a corporation can generate more than a dollar of value with every dollar of reinvested earnings—or it can't. If it can, earnings should be retained. (Shareholders who need income should gradually sell shares—income does not have to come in the form of dividends.) On the other hand, if a corporation cannot create more than a dollar of value with each dollar retained, then earnings should be distributed to shareholders. If a corporation contends that retained "earnings" are a necessary (survival) cost of staying competitive, then the corporation isn't correctly accounting for all of its costs. ***Earnings that must be retained to stay competitive aren't really earnings—they are costs***.

How does Berkshire manage risk and correlation?

An individual from New Jersey asked Buffett how he manages risk at General Re and National Indemnity. Specifically, how does he avoid correlation [of risks]? Addressing correlation, Buffett noted that if a large earthquake occurred in the wrong place in California, for example, there could be all kinds of secondary and tertiary problems. "When there's trouble, everything correlates … It's my job to worry about the worst case." The most likely "mega-cat" disaster would be a major hurricane or earthquake, and the likelihood of a very costly earthquake is comparable to that of a Category 5 hurricane. He added that severe earthquakes have occurred in unexpected places—like New Madrid, Missouri (which has experienced magnitude 8 quakes). A few years ago, Berkshire didn't exclude nuclear, chemical and biological risks from its insurance policies, but now it does. Otherwise, Berkshire would be "vulnerable to extinction." Buffett gave examples of some of the insurance Berkshire has written, such as policies covering cancellation of the NCAA Final Four basketball tournament and the Grammy Awards, and excess coverage for a large international airport. "We are willing to lose a lot of money in one day, but we're not willing to do anything that would make us uncomfortable writing checks in the morning." He noted that "we worry more about the downside than most … It's Armageddon around here every day." He concluded by commenting, "The idea that you'd risk something that's important for something that you don't need is ridiculous."

> Comment: We think investors should zero in on, "When there's trouble, everything correlates." Amen. A lot of what passes for asset allocation nowadays boils down to using mathematical techniques to reduce perceived risk for a given return (or to maximize return for a given level of perceived risk). This approach requires knowledge of the correlations between various asset classes, and not enough thought has been given to the subject of asset correlation. Instead, asset allocators commonly use ***average*** correlations, even when there is considerable variation in correlations over time. As you might suspect, the math of asset allocation is only as useful as the correlation coefficients are accurate. The trouble is, as Buffett points out, in times of economic stress (e.g., during a currency crisis or in the depths of a bear market) asset price correlations shoot upward, rendering mathematically based asset allocations nearly useless—just ask the former managers of the Long Term Capital Management hedge fund.

Is gold a viable investment?

A shareholder from Austin, Texas asked whether gold can be considered a viable investment alternative to paper currency. Buffett replied, "We're not enthused about gold." He said he'd prefer an asset that's going to be useful, such as "oil, land, See's Candies or Coca Cola." He added that "we wouldn't trade those real assets for a hunk of yellow metal," noting that gold hasn't provided a very high return over the decades. According to Munger, "When you have the opportunities of Berkshire, gold is a dumb investment."

> Comment: Buffett and Munger were pretty blunt about their opinions on gold, and from the historical record it's hard to disagree. At best, gold has kept pace with inflation over the long term—but that's no great claim to fame. Nowadays, investors who want to keep pace with inflation can purchase Treasury Inflation-Protected Securities (TIPS), which rise in value along with

inflation ***and*** provide a small additional yield. As Munger suggests, for intelligent investors who are tolerant of the volatility of stocks, the opportunity for meaningful real (above inflation) growth in equities is an attractive one.

What does Buffett fear?

An English investor asked Buffett about his greatest fears regarding Berkshire operations, apart from insured catastrophe. Buffett replied that Berkshire has a diverse group of companies with good managers, yet something can always go wrong. Berkshire tries to create a culture and incentives that minimize the chance of something going wrong. Buffett: "When I'm flying on a NetJet, the last thing in the world I want to do is to tell the pilot I'm in a hurry." He stressed that incentives are important, and that many companies have the wrong incentives incorporated in their compensation plans and in their emphasis on quarterly earnings. Concerning Berkshire's companies, Buffett said that his managers shouldn't have to worry about quarterly reports and submitting budgets to Omaha. He noted that "you can report any [earnings] number you want in a given quarter by writing long-tailed [insurance] business," and he thought it would provide the wrong incentive to Berkshire's managers if they thought Berkshire had to report some predicted amount of earnings each quarter. In that case, managers might be tempted to do the wrong things "to avoid disappointing Warren." Buffett noted that the problem at Berkshire is not having the wrong incentives, but rather deploying capital. Munger quipped that the unreasonable expectation—issued from [various] corporate headquarters—that earnings will grow without volatility every quarter "is not just the kissing cousin of evil, it's the blood brother of evil." According to Buffett, companies don't need "financial or psychological pressures" to do things they know they shouldn't. He maintained that "you are only kidding investors, or yourself, if you think you can meet short-term predictions."

> Comment: Buffett and Munger do investors a great service by focusing on incentives and the problems caused when investors and analysts demand smoothly growing corporate earnings. Simply stated, it is very much at odds with economic reality for a corporation to grow at a uniform rate. Indeed, we get suspicious of even the appearance of uniform growth—or uniformly "beating the street." (At one point during the late 1990s tech bubble, Cisco Systems beat analysts' earnings estimates by exactly one cent per share for 12 consecutive quarters—an unbelievable occurrence.) Wise long-term investors shouldn't get rattled when earnings temporarily slow, just as they shouldn't get overly enthusiastic when earnings temporarily accelerate. Back to the subject of incentives, Roger Lowenstein's *Origins of the Crash* (reviewed at www.jvbruni.com/Bookreviews4.htm) does an excellent job of explaining how powerful incentives during the tech bubble—such as an overabundance of traditional stock options—led to misleading research reports, inappropriate mergers and acquisitions, compromised accounting and other problems.

How does one predict success?

A shareholder from San Francisco mentioned that in Berkshire's annual report, Buffett said that extraordinary business ability is innate. The shareholder then asked Buffett how to predict which managers will succeed. Buffett replied that he cannot go to an MBA class of, say, 50 and rank their future success by grades, talking to the students, etc. It is hard to tell in advance, before they have a record, so Berkshire does things the easy way—"dodges" the issue—by looking at their batting averages. "It's far easier to tell great baseball players after seeing their batting averages for a couple of seasons." The best correlation with future business success seems to be the age at which someone starts a first business—the younger the better. (Munger later revealed that he loved games of chance at an early age—and he loved winning at them.) Buffett added that a lot of business success—more than he would have thought a few years ago—is "wiring." Munger added, "Part of it is intelligence, and part of it is temperament." He remarked that sensible people with the right temperament will succeed.

> Comment: Without being blatant about it, Buffett sometimes modifies his shareholders' questions in order to provide a more useful answer. In this answer, Buffett said that he tries to ***observe*** success, not predict it. Observing is far easier than predicting, of course, so it's amazing how frequently investors fail to observe the obvious. For example, pay attention sometime to the commercials on business TV. You may see ads that emphasize how much some investment firm ***cares*** about its clients—without any mention of how well the firm has ***performed*** for its clients. Other ads promote the benefits of online trading, yet we've never heard online trading firms mention the rates of return earned by active traders. This information exists, of course, but the reality is that emotional appeals, not objective and observable facts, sell. It is a triumph of marketing over reason that so much money is handled by firms with poor long-term results. Simply put, investors would be wise to evaluate long-term batting averages when deciding where to put their money, just like Berkshire does.

Should investors diversify out of dollars?

An attendee from Sacramento asked whether individuals should worry about the declining dollar and whether they should diversify into non-dollar denominated investments. Buffett replied that this is very difficult for individuals to do. He said that "the best investment you can have is in your own abilities or business ... If you have a good business in the U.S. earning dollars, you'll do okay." Munger noted that he and Buffett are looking for opportunities, and they don't really care what categories they're in. He added, "We're totally out of step with modern money management, but we think they're wrong." He then asked Buffett, "When was the last time you sat down and wrote out an asset allocation plan?" Buffett: "Never." Concerning asset allocation, Munger deadpanned, "If a thing is not worth doing at all, it's not worth doing well."

Comment: Once again, a blunt answer—this time addressing asset allocation. Given the limitations of asset allocation strategies as typically employed (see our earlier comments), we've concluded that asset allocation schemes are used more to intimidate those unfamiliar with the math involved than to create a useful investment strategy. Put differently, asset allocation is more about investment ***sales*** than investment ***results***.

What about the dollar and inflation?

A shareholder from Massachusetts asked to what degree Buffett expected a decline of the dollar to contribute to inflation and to affect Berkshire's performance. Buffett answered that "inflation destroys value unequally." The best businesses, like See's Candies, don't require continuing large capital investments in order to retain their value. In comparison, airlines have been hurt by having to make continuing big capital investments in aircraft. Buffett cited the professional skills of brain surgeons and lawyers as examples of good inflation-proof investments. He believes that while inflation has always been with us and always will be—"we think it's in remission"—it is not a factor to the exclusion of all others. Buffett noted that talk of deflation not that long ago was "nonsense." He added that the declining dollar adds to inflation—it can contribute to higher oil prices, for example. Munger mentioned that some of the factors contributing to the dollar's decline (specifically, overseas companies' cost competitiveness) have been restraining inflation.

Comment: The kernel of Buffett's response—that inflation destroys value unequally—is hard to argue with. In inflationary times, companies that continually require significant additional capital equipment have to fork over ever more of their shareholders' cash. It can be a complex task, however, to thoroughly analyze how inflation affects companies. It's possible to argue, for example, that capital intensive companies with modern equipment and long-lived assets may actually benefit (for a period of years) by inflation's burden on competitors that have yet to modernize. On the other hand, after a bout of inflation, it is possible (and perhaps likely) that as companies depreciate their pre-inflation capital equipment, they may be under-depreciating their existing assets (and overstating income). In addition, companies without significant capital requirements, but with significant labor costs, may find their costs escalating as much as companies with a much higher proportion of capital costs. Speaking for ourselves, we would generalize that over the shorter term (several years), companies with more variable costs (capital, labor or otherwise) are more adversely affected by inflation than companies with relatively more fixed costs. However, over the longer term most costs become variable—and thus subject to the impact of inflation.

Concerning Buffett's "remission" remark, we've felt the same way for a number of years. Although Buffett didn't expand on his inflation concerns, it's possible to look at inflation as a national equalizer—something that brings legislated benefits and economic reality into balance, when necessary. For example, if Congress enacts legislation aimed at providing more than the country can produce—be it more retirement benefits, healthcare, national defense or chickens in various pots—something will have to give. Inflation sometimes rises in order to deny—some might say tax away—legislated benefits that are beyond our production capacity.

Strategies for a bear market?

A physician from Saint Louis asked what strategies Berkshire would employ if there is a dismal stock market over the coming years. Buffett replied, "If the market gets cheaper, we will have many more opportunities." He added that in a general way, he and Munger knew that they were getting incredible bargains in the 1970s. He also noted that he buys groceries and would continue to buy groceries—and investments—in a down market. "We'll be buying things for as long as I live." Munger: "Longer, Warren." According to Buffett, "We spend no time thinking or talking about what the stock market is going to do, because we don't know." They don't focus on "macro factors," either. Buffett believes that there's always a list of reasons why there will be problems, but there are always opportunities. Later he said that he has seen people pass up opportunities because they got focused on single issues or problems. Buffett: "I am an enormous bull on this country—it's an incredible success story ... It does not make sense to bet against America." Munger shared his personal belief that "we are at or near the apex of a great civilization." (One of us noted Buffett responding that he did not feel that way.)

> Comment: Here's yet another information-packed answer. Although it's theoretically possible that time spent pondering the overall movement of the stock market might aid an investor, we frankly doubt it. Most intelligent investors will find their time much better spent focusing on the details of specific investments. Buffett's comment that he tries to take advantage of opportunities that develop in bear markets is consistent with his long-term orientation. In general, investors who are saving and accumulating wealth should prefer weaker markets in the near term and stronger markets later on. However, investors who are currently in the withdrawal phase of their investment cycle should hope for the opposite. (We've written an article, available at www.jvbruni.com/commentary-adaptive5.htm, on how the timing of investment returns affects savers and spenders differently.) Buffett noted that there are always reasons for investors to be concerned, and we would add that these reasons typically get the most ink during down markets. ***Press coverage is a coincident, not leading, indicator of stock market performance.*** The economic and investment news appears to be the worst at market bottoms, and it appears to be the best near market tops. To verify this observation, review newspaper headlines from a few days after the market crash of October 19, 1987 (when most stocks fell over 20% in one day) and then review headlines near the peak of the recent bubble in early 2000. Buffett makes a salient point about investors' tendency to get hung up on one concern, whether it be the dollar, the budget deficit, inflation, short-term

economic activity or whatever. Finally, while the U.S. economy will always have some problems, it has been and is without peer among the major economies. On the basis of history, investors would need to have rocks in their heads to be long-term bears on America.

What's the outlook for GM and Ford?

A shareholder from Chicago asked Buffett what he thinks will happen at GM and Ford, given their huge liabilities [for healthcare and retirement benefits]. Buffett replied that GM and Ford's current managers have been handed [by previous managers] "extremely difficult hands to play." They have contractual cost commitments, negotiated many years ago, that are "staggeringly" high compared with their competitors. In short, it's a "very, very tough situation." Buffett noted that GM has pension fund obligations of $90 billion, whereas it has an equity market capitalization of only $14 billion. Part of the reason for GM's predicament is that accrual accounting for retirement obligations wasn't required until the 1960s and for healthcare obligations until the 1990s. Munger: "Warren gave a very optimistic prognosis." He also noted that the automakers' problems need to be addressed ***now***. "If you jump out of a window on the 42nd floor, just because you're still doing fine at the 20th floor doesn't mean you don't have a serious problem."

> Comment: Investors should remember Munger's remark about the jumper's condition as he passes the 20th floor. It's clear that something dramatic needs to happen to rescue GM and Ford from their predicaments. Pick up any consumer or automotive magazine and read its assessment of GM and Ford vehicles compared with their competitors—it may not be a pretty story. Now add in the significantly higher production costs at GM and Ford, partly due to "legacy" retirement and healthcare expenses, and connect the dots. Focusing on GM as an example, its options seem limited. Perhaps GM could dramatically improve the quality and appeal of its autos ***relative*** to its competitors. (Well … maybe GM could catch the competition, but as they say in Missouri, "show me.") Perhaps GM could negotiate significantly lower personnel costs with its unions, including retiree costs—although this seems like a long shot, too. Perhaps GM could somehow offload its burdensome retirement costs to the Pension Benefit Guarantee Corporation (read: the taxpayer), with or without a formal bankruptcy. It's also possible that currency exchange rates will change to the point that imported cars and trucks become much more expensive to U.S. consumers. However, foreign automakers already produce many autos in North America, so this may have limited benefits. All told, GM's picture isn't a pretty one, as Buffett and Munger said. What about Kirk Kirkorian's recent offer to buy more GM shares? Frankly, although he is a savvy investor, we don't understand his logic. Most investors don't need to have an opinion about GM; however, we'd like to use Buffett's GM comments to stress how important it is to investigate whether companies have retirement-cost time bombs ticking. Indeed, absent a taxpayer bailout, retirement costs may bankrupt a number of

large companies. It also doesn't help that many companies currently understate their retirement and health care obligations.

"Shenanigans" at the New York Stock Exchange?

A New Yorker asked Buffett to comment on "shenanigans" at the New York Stock Exchange. Buffett replied that he thought it would be better if the NYSE remained a neutral "not-for-big-profit" institution. He added, "The enemy of investment performance is activity." Buffett also said that he didn't want a stock exchange that promoted trading [out of self-interest], because American investors would be hurt. He commented that trading costs are a "frictional cost of capitalism," and that IBM and GM will not earn more money if their stocks turn over more. Munger added that while he agreed with Buffett, he felt even more strongly that "we have lost our way on this stuff." He stressed that the leaders of the NYSE have lost their role as exemplars. "They have a duty to create the right appearances and act as exemplars … I don't want to turn a major stock exchange into a casino."

> Comment: It's hard—very hard—to see how a for-profit NYSE would be advantageous for most investors. Over the long term, stock investors as a group achieve a return determined by the growth of the U.S. economy, minus various costs of intermediation, such as commissions and other trading-related expenses. The more profit the NYSE earns from commissions and member trading, the less investors will gain. In addition, the last thing the NYSE should do is promote yet more hyperkinetic trading. The Buffett quote that says it all is, "The enemy of investment performance is activity."

What's different between 1969 and now?

A shareholder from Hong Kong asked how today is different from 1968 – 1969, when Buffett liquidated his investment partnership. Buffett replied that Berkshire owns some securities that he wouldn't buy at today's prices—and this is related to the quantities they own of these securities, plus taxes and transactions costs. He stated that he isn't unhappy with Berkshire's investments, although he noted that a lower percentage of Berkshire's net worth is now in stocks than at almost any other time. Buffett explained that there is a "zone" [of valuation] within which, due to taxes and expenses, Berkshire is neither a buyer nor a seller. Munger added that although Berkshire's last few purchases were relatively small (though still in the billions), these investments have performed as well as any, and he didn't see their present difficulty making large purchases as a permanent state of affairs.

> Comment: Buffett's "zone" comments are intriguing. It doesn't make sense for a stock to be a buy at $50.00 and a sell at $50.01. There should be a neutral range between buying and selling, due to the factors Buffett mentioned (taxes and other expenses) and, we'd add, due to the inability of investors to

precisely evaluate companies. In general, we like our purchases to be priced attractively enough to provide an appropriate margin of safety, and we like to sell when that decision seems obvious. Between buying and selling, we practice patience. Interestingly, many investment research reports don't identify price zones to buy, hold and sell. However, every sensible investment recommendation should include the price range to which it applies. If there isn't a stated price range, then it's an incomplete analysis.

What about commercial real estate?

A Californian asked about investing in commercial real estate. Munger replied that due to taxes, C-corporations like Berkshire are grossly disadvantaged versus individuals and Real Estate Investment Trusts (REITs) when investing in real estate. He also felt that commercial real estate has some bubble valuations and related that a number of investors have sold some of their worst properties at very high prices. Buffett noted that he has less than one percent of his net worth outside Berkshire shares, and during the [late 1990s] bubble he had all of it in REITs. He currently regards REITs as unattractive for individuals, certainly relative to five years ago, and even more so for corporations. Buffett suggested that "it's better to pay attention to something that's being scorned than something championed." Besides, said Munger, "REITs have phony accounting."

Comment: Buffett's remark that it's better to focus on "scorned" investments than overly popular ones is a great piece of advice. Investors who seek to buy low and sell high should ask themselves what makes "low" low and "high" high. Generally, investments aren't on the bargain counter because they are popular. Indeed, the opposite is true. Unpopular (or perhaps unknown or unappreciated) investments are cheap, and the intelligent investor would be wise to determine which unpopular investments are undeservedly so. Similarly, investments are priced high because they are popular—sometimes wildly so. Wise investors should also try to determine which popular investments are overly popular, given their investment fundamentals.

Is the U.S. a castle with a moat?

A Kansas shareholder asked Buffett whether the U.S. is "a castle with a moat," and if it is, how can we enlarge the moat? Buffett replied that over the last 215 years the U.S. has done much better than the rest of the world, but the U.S. isn't an economic castle. The rest of the world is catching on—adopting some of the "best practices" of this country. Buffett: "The more trade we have, the better." Buffett noted that our prosperity won't come at the expense of the rest of the world. Munger added that if, 50 – 100 years from now, the U.S. is in third place [economically] to some country in Asia, we will still have grown economically, but it will be an odd sort of increase. All told, Munger said, Asian countries will probably do the best in terms of annual percentage gains.

Comment: We selected this question because Buffett—unlike some others who have expressed concern about the trade deficit—is not opposed to international trade. Indeed, he remarked that "the more trade we have, the better." Trade lies at the heart of the enormous leap in worldwide economic growth that has occurred since the time of Adam Smith. Trade, whether it is intercity, interstate or international, allows goods and services to be produced wherever they can be produced comparatively best. (Economically, it doesn't make a major difference whether the political boundaries crossed by trade are city, state or national ones.) The polar opposite of trade, economic isolation, is a prescription for lower standards of living.

What about corporate directors?

An individual from Connecticut asked about corporate directors' responsibilities. He also asked how Berkshire selects directors. Munger replied that modern practice is to have [on corporate boards] a representative from each diversity group and to have directors who need the $100,000 annual fee. Munger: "We are completely out of step with modern practice." Berkshire has directors who are rich, don't need the pay, aren't picked to represent a diversity class, are knowledgeable, own lots of Berkshire stock and don't receive liability insurance. Buffett added that the problem is that it's difficult [for a director] to "lead a charge" when he's a notch above mediocrity and needs his board income. "Independence is a state of mind." It's a willingness (not eagerness) to challenge. He noted that Munger and he have been on boards where they needed to work to restrain their "obnoxiousness." According to Buffett, Berkshire's board has "real owners, who bought their shares just like [the public] does … Nobody handed them any shares or options." Munger added that a director who needs his $150,000 director's fee cannot be independent—"They're automatically insiders … Directors have to be willing to leave office at any time." Buffett reiterated his point that "boards typically fill their compensation committees with Chihuahuas—not Great Danes or Dobermans," adding that he didn't mean to insult any Berkshire board members who sit on compensation committees. [Tongue in cheek] he then wondered aloud whether he and Munger had missed insulting anyone. "You insulted the dogs," quipped Munger.

Comment: As Buffett and Munger's comments suggest, it is easy to be disappointed with the current state of corporate governance. Although the situation is slowly improving, corporate directors who work primarily in the interest of their shareholders are the exception to the rule. Consider, for example, the directors of the fictitious Acme-Zebra Mutual Fund. These directors owe fiduciary responsibility to the fund's true owners—its shareholders. Therefore, directors should hire the best fund managers from among the hundreds (or thousands) of candidates. Instead, they typically hire the same management company year after year after year—sometimes in spite of clearly sub-par performance. This sad state of affairs, unfortunately, is part of the current state of corporate governance.

What's the outlook for the pharmaceutical industry?

A shareholder from North Carolina asked Buffett to comment on the long-term prospects for the pharmaceutical industry. Buffett replied that he didn't know enough to answer the question. Munger added that "we just throw some decisions into the 'too hard' pile and go on to something else." Buffett expanded on that comment by saying, "There is wisdom in that. There are some decisions in life that are just too hard … there's no reward for 'degree of difficulty' in investing" as in Olympic events like gymnastics or diving. "We get paid not for jumping over seven foot bars, but for stepping over one foot bars."

> Comment: As Buffett and Munger explain it, it's pretty obvious that investors should prefer easier decisions to harder ones, particularly if they are paid the same for success in either situation. Indeed, if markets were anywhere near as efficient as some academics suggest, one would expect the stocks of hard-to-predict companies to sell at discounts compared to the valuations of easier-to-predict companies. After all, who would willingly accept more uncertainty without a price discount? Remarkably, however, sometimes we see stocks of companies with lots of uncertainty selling at ***premium*** valuations. How can this be? We'd suggest that there is a "lottery effect" component in the pricing of many high tech and biotech companies—such that investors pay up for the potential of a home run, even in the face of uncertainty and long odds. As with most lotteries, however, it's typically not a smart bet.

How can investors overcome emotional traps?

A New Yorker asked Buffett how individual investors can overcome psychological and emotional traps, like "anchoring" (fixating on a price), when even Buffett has admitted falling into them. Buffett replied that, first, it is important to recognize that these traps exist. Second, he recommended reading *Poor Charlie's Almanack: The Wit and Wisdom of Charles T. Munger* [yes, Almanack with a "k"], a compilation of Charlie Munger's lectures and thoughts. According to Munger, "You don't need perfect wisdom to get rich—you just need more wisdom than the next guy over the long term."

> Comment: We have not been disappointed in any way with Munger's wide-ranging, 400+ page book—a bargain at $49.00. (You can order a copy at www.poorcharliesalmanack.com—net proceeds go to the Munger Research Center.) A number of the essays and articles in the book have appeared elsewhere, and we found them to be illuminating. There are no perfect recommendations in the world of investments, but we think almost everyone who enjoys a Berkshire Hathaway annual meeting will benefit from—and enjoy—Munger's book.

Advice for young investors?

The last question in this summary wasn't the last question at the Berkshire meeting—it was the fourth, actually. We're putting it last because we think it is a fitting capstone to Buffett and Munger's five-hour session with their shareholders. A shareholder from Council Bluffs, Iowa asked when Buffett became interested in investing, and what advice he would give to young investors. Buffett replied that his interest started at about age seven and that "I wasted my life before that." He quoted W. C. Fields, who said that he'd spent half his money on whiskey and the rest he'd wasted, which got a big laugh from the audience. Buffett's father was a stockbroker, and Warren said that he followed his dad downtown to his office on Saturdays and read every book on investing in his dad's library—and in the Omaha public library. At age 11, he bought his first three shares of stock. When Buffett's father was elected to Congress, Warren read investing books from the Library of Congress. His "whole framework" changed when, at age 19, he read Benjamin Graham's *The Intelligent Investor*. "Read everything in sight and start young—and you'll do well." Buffett went on to say that "there are no secrets that only the priesthood knows." Successful investing requires a quality of temperament more than a quality of intelligence. Think for yourself, have a good framework—look for one that's been successful—and look for opportunities within your framework. You can't "do something" [invest] every day, other than to learn. Munger recalled Keynes' reference to money management as a "low calling," and he added that corporate managers should study investing in order to make themselves better managers. He thinks that the present era of "frenzied imitation," with so much intelligence focused on investments, is unprecedented. Buffett agreed that corporate managers should study investing, and he recounted how acquaintances of his—corporate CEOs—have other people investing their [personal] money. Buffett finds it extraordinary that these CEOs handle multi-billion dollar business acquisitions, yet they don't think they are able to manage their own investments.

> Comment: If you want to improve your investing, you should study the best practitioners. Buffett studied under Benjamin Graham, and you have the opportunity to study Graham, Buffett and other successful investors by doing what Buffett did—read. Investors can learn from their own experiences and from the experiences of others. Learning through one's own experiences, though necessary, can be time consuming and very expensive. Learning from others (through books) is not only wise in terms of time and money, it's essential in order to gain a broad perspective. Out of the many investment related books that we've read, we have written reviews of our favorites—including many focused on Graham or Buffett. Our reviews are available at www.jvbruni.com/Bookreviews4.htm. Happy reading—and learning.

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