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# *The 2006 Berkshire Hathaway Annual Meeting*
# *Top 20 Questions*

During the question and answer portion of the 2006 Berkshire Hathaway annual meeting, shareholders asked Warren Buffett and Charlie Munger a total of 46 questions. Many of these questions were 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 this article is billed 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 we considered to be the most helpful for individual investors. In addition, although Buffett and Munger need no clarification, we've supplemented their answers with elaborating—and sometimes tangential—comments.

The ground rules at Berkshire meetings include a ban on recording devices, so the following material is based on four individuals' 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 words varied from our notes. In all cases, we have tried to remain faithful to Buffett and Munger's wording and intent. Nevertheless, please note that neither Buffett nor Munger has reviewed or endorsed our summaries of their comments or our own.

Jerry Bruni and Sarah Roach collaborated on this article. Sarah distilled some 80 pages of handwritten notes into an accurate summary of the 20 questions and answers. In addition, she provided important editing of this entire article. Jerry was the primary author of our elaborating comments. First-person references in these comments refer to his views, and he is solely responsible for any errors or omissions.

## Management Compensation.

A shareholder from California asked how to design a management compensation package in a cyclical industry.

> Buffett: In the [cyclical] copper industry, even the village idiot could make money [today]. At Berkshire, we have a wide variety of compensation systems. If Berkshire owned a copper company, we'd measure executive performance more from a cost of production standpoint—something that wouldn't fluctuate a lot. Try to focus on what managers can have an impact on rather than on things management can't control. At GEICO, we focus on growth, but growth costs money, so we value profits in seasoned business. Among major oil companies, there's been a huge difference in finding costs. A compensation system could focus on low finding costs.

Munger**:** It's easy to have a fair compensation system. About half of companies have grossly unfair systems, but our influence has been about zero.

Buffett: In our operating companies we've never used a compensation consultant. The subsidiaries may have, but they're smart enough not to come tell me! It's not rocket science. [Corporate executive compensation systems] are more complicated and confusing than they need to be and work to the advantage of the people who have their hands on the switch.

Munger: Warren and I were on Salomon's compensation committee, [and we saw that] a "frenzy of envy" characterized investment banking.

Buffett: It's more an "envy" problem than a "greed" one. Someone making $2 million is fine until he hears about someone making $2.1 million. Of the seven deadly sins, envy is the silliest because it doesn't make you feel better—unlike gluttony . . . or lust. Gluttony has its upside. (laughter) Envy is the only sin that doesn't make you feel better, and it's a big part of human nature. Envy just makes you feel sick all of the time. The SEC's drive for transparency has led to more envy.

> Comment: As Munger noted, many companies have grossly unfair compensation systems—primarily designed, it seems, to enrich management. Moreover, the role of compensation consultants too often amounts to providing a fig leaf of justification for—and sufficient complexity to hide—excessive compensation. High compensation isn't necessarily excessive, of course. So how should compensation be determined? Although I'm not at all sure that Buffett and Munger would agree with me, an individual's value-added is very hard to measure, and it isn't necessarily the best approach to take. Consider, for example, the (fictitious) Acme-Zebra Corporation's CEO, Sam Smith, who makes decisions that ultimately add $50 million of value to the company. It doesn't necessarily follow that Smith is entitled to $49.9 million in compensation. Why not? To begin, employees are supposed to create ***more*** corporate value than their compensation, and that value belongs to the corporation's owners. Employees who want to share in corporate value creation can—and should—do so as shareholders. Further, in the case of Acme-Zebra, suppose that a different CEO would have made decisions that created $75 million of value for the company. Now what's the "value" of CEO Smith? When it comes to executive compensation, perhaps corporate boards should think more like economists, who typically consider opportunity costs. For example, if it takes $5 million to attract a CEO—with the necessary technical and leadership qualities—away from that individual's other employment opportunities, most economists would say that $5 million is an appropriate amount of compensation, even if the CEO creates $50 million of corporate value. (By the way, CEOs aren't solely responsible for value creation.) If a company pays its CEO $5 million when it could hire an equally (or more) capable person for $3 million, then it is paying $2 million too much. While there are many highly competent CEOs in corporate America, I think many observers would agree that there are also many deep benches. It's hard, frankly, to imagine many situations in which compensation running in the tens of

millions is necessary to attract fully qualified managers. In short, compensation should serve to attract and retain the appropriate executive skills, not to hand managers the value they create for the corporation. Corporate value created by employees (including CEOs) that's in excess of their necessary compensation belongs to the corporation's owners.

### Corporate Culture.

A shareholder from Bonn, Germany asked Buffett how he trains his successors. What's important and how do you measure whether managers are living up to expectations?

Buffett: Part of the reason the Berkshire shareholder letter is written is to convey to the shareholders, the public and our managers how we work. The letter and this meeting give character and culture to Berkshire Hathaway. That's training in itself. Just like children learn a family's culture. We try to do everything consistent with our culture. It doesn't require formal lessons. We want managers to join us that believe in our values. Those that don't agree with us don't join us. We're looking for partners—a lifetime commitment. Our culture is so well-defined that there aren't many mistakes.

Munger: "If Warren has kept the [culture] faith until he's 75, do you really think he's going to blow the job of passing the faith on?" We don't train executives, we find them. It's not hard to find great managers. If a mountain stands out like Everest, you don't have to be a genius to see that it's a high mountain.

Comment: Although much has been written about Buffett's skill at business evaluation, one of his less-recognized—yet critical and quite remarkable—skills is his ability to attract and select the right kind of managers. (Indeed, investors would do well to copy Buffett by spending time evaluating the character and vision of CEOs.) As Buffett and Munger have repeatedly told their shareholders, they seek managers with vision and a lifetime commitment—and they frequently find such people among company founders with very large ownership interests in their companies. As Buffett and Munger recognize, long-term decision-making isn't necessarily hard to do, but it becomes more difficult when there are numerous incentives to sacrifice long-term success for short-term gain. Nowadays, the most dangerous short-term incentives sometimes come in the form of poorly designed stock option plans. For companies that want to give their executives stock, we would prefer granting restricted stock that can't be sold until five years after the employee leaves the company. Berkshire's strong corporate culture doesn't include stock options, yet despite—or perhaps because of—the absence of options, the company has been exceedingly successful.

### Corporate Governance.

A shareholder from Elkhart, Indiana asked for Buffett's opinion regarding the concept of majority voting, versus plurality voting, for corporate directors.

Munger: I don't think it will have any effect at all. Fashions come and go in governance, [and] governance reformers have to be considered activists—which is a mixed crowd.

Buffett: You have to understand the situation in the boardroom—it's partially a business and partially a social situation. The question is to what extent people [directors] think like owners. There are enormous differences in the extent of business savvy. The key job of the board is to get the right CEO and keep him from over-reaching, and the board has to exercise independent judgment on acquisitions. American directors haven't distinguished themselves. The only cure [for poor corporate governance] is if the largest shareholders—the eight to ten largest institutional investors in the country—zero in on these areas. It will take the big shareholders, not coalitions of small holders, to make a difference. [Unfortunately], some large institutional investors have farmed out [their proxy voting responsibilities].

Comment: Buffett provided a broad and meaningful answer to a narrowly defined question. Corporate boards currently range from great to awful, and the overall pace of improvement has been distressingly slow. Boards of directors ultimately answer to shareholders. Therefore, if corporate governance is going to change for the better, change needs to start with informed and involved shareholders. Given the realities of shareholder ownership in America, the manner in which the largest shareholders—typically institutional investors—conduct themselves is vital, because they control such large portions of corporations' shares. However, as Buffett pointed out, some institutional investors apparently don't consider their shareholder voting responsibilities important enough to make their own decisions. Sometimes I wonder whether such neglect is intentional. Here's why: If XYZ Capital Management is a shareholder in Acme Widget and bids to manage Acme's pension plan, XYZ could well lose its bid if Acme's executives discover that XYZ voted against a generous stock option plan. Frankly, it's no wonder that a number of investment management firms fought against having to disclose their voting actions, and perhaps it's also no wonder that some have decided to farm out their voting responsibilities. There are parallels between corporate governance and political governance: In both cases, informed and involved voters get the best governance—and uninformed, uninvolved voters get a steady diet of rhetoric and excuses.

## Circles of Competence.

A shareholder from Michigan asked Buffett what he had learned about tech companies such as Cisco, Sun, and Intel.

Buffett: I've learned that I don't know enough. We have a circle of competence. You [shouldn't] get into businesses where the future is so likely to be different from the present—there may be very few people with the insight to evaluate them. We are best at businesses that will look in 5-10 years like they look now—where the business fundamentals don't change. Telecom [in contrast] has experienced startling change. Charlie says we have three boxes: "In," "Out," and "Too Hard." We try to stay within our circle of competence. If you run fast, you don't have to throw the shot put—someone else can do that. I think it was Tom Watson, Sr. [founder of IBM] who said, "I'm no genius, but I'm smart in spots and I stay near those spots." We get no inferiority complex at all [from not understanding technology]. What is Intel going to look like in five years? I haven't any idea. I'm not so sure you can predict even from within an industry.

Munger: A foreign correspondent said to us, "You don't seem smart enough to be doing so much better than the rest of us." We said we know the edge of our competency better than most people do. "It's not a competency if you don't know the edge of it."

Comment: I never get tired of hearing Buffett talk about staying within one's circle of competence, because investors—individual and professional alike—who stray from their areas of competence frequently suffer the consequences. Most brain surgeons wouldn't attempt to fly a commercial aircraft, most airline pilots wouldn't try to become professional athletes, and most athletes know better than to start a law practice. However, when it comes to investing, too many surgeons, pilots, athletes and attorneys barely give a second thought to investing their life savings—an activity not necessarily within their circle of competence. Similarly, too many professional investors have flirted with technology stocks or foreign stocks that they didn't really understand. Given the paramount importance of staying within one's circle of competence, it's amazing that Buffett regularly takes flack for avoiding investments he doesn't thoroughly understand. Frankly, what some label a limitation is really a strength.

### Hot Ideas.

A Kansas City shareholder asked Buffett's opinion about the economics of ethanol and its outlook as an investment.

Buffett: We don't know enough to predict earnings on capital five years from now [compared to] See's Candy or Coke. It's hot, and we don't generally focus on things that are hot. Generally speaking, agricultural processing hasn't earned high returns on capital. I don't know how you gain a significant competitive advantage.

Munger: My attitude is even more hostile than Warren's. I suspect it takes more fossil fuel energy to create ethanol than you get from the ethanol produced.

Buffett: I have friends who like ethanol and friends who don't like ethanol, and I want it to be known that I stand up for my friends. (laughter)

Comment: Buffett packed a lot of wisdom into a short answer: Investors should avoid hot concepts (they are frequently overpriced) and focus on businesses that are capable of creating and maintaining a competitive advantage. To do otherwise is to invite poor results.

### Market Bubbles.

A shareholder from Hanover, Germany asked whether we're in a commodity bubble.

Buffett: Not in agriculture, but in oil and some metals there's been a terrific price move—most extremely in copper. Like most trends, in the beginning it's driven by fundamentals, then speculation takes over. "What the wise man does in the beginning, the fool does in the end." Speculative participation can become dominant, the most extreme example being tulips [referring to the tulip mania of the early 1600s]. Once a price history develops that people have never seen before, envy steps in. My guess is that a lot of activity in copper now is speculative. How far it goes you can't tell. Fundamental forces become speculative forces.

Munger: We've demonstrated how little we know about commodities by our activities in silver.

Buffett: I bought [silver] early and sold early. Silver was my fault. [Speculation] is wildest at the end. Like Cinderella at the ball, at midnight everything turns into pumpkins and mice. Everyone wants to dance one more dance, and everyone thinks they'll get out just before midnight. But there are no clocks on the wall.

> Comment: As Buffett pointed out, many speculative bubbles begin quite reasonably. For example, suppose the price of dilithium crystals has been depressed, and prices have recently begun rising. If the past is any guide, eventually some investors will begin thinking less about dilithium supply and demand, and more about what the next investor is going to do. This is when speculation starts. As prices continue to rise, many investors (speculators, really) will focus almost exclusively on price momentum—even while parroting the original supply-and-demand story. When this happens, the bubble is closer to bursting. Remarkably, many speculators may well suspect that price gains are excessive and can't be sustained indefinitely. Nevertheless, bubbles being what they are—addictive manias—almost everyone thinks they will be able to sell very close to the peak, even though it's obviously impossible for everyone to do so. The rest is history—time and again.

### Investments in Developing Countries.

A University of Kansas student from Brazil asked Buffett what he thought about investments in South America.

Buffett: Our problem is that we've got so much to invest. We need to buy hundreds of millions of dollars to move the needle. That limits the countries where we have opportunities. We could only get $400 million into PetroChina—one of the top five oil companies in the world—even though we wanted more. Brazil would not be ruled out—I should have bought a Brazilian beer company owned by a friend years ago. We would want to get a better return [in Brazil, China, etc.] due to our poorer understanding of tax laws, governments [etc.]. [Purchase prices] need to be cheaper than in the U.S.

> Comment: Investing in developing countries exposes investors to risks not necessarily present in more developed nations. Therefore, it's appropriate for investors to target higher returns by insisting on lower stock prices in relation to economic fundamentals. Generalizing beyond international investing, whenever risks are higher, stock prices should be lower. One of the remarkable aspects of the late 1990s technology stock bubble was that risky, untested companies were priced higher, not lower, than many attractive, lower risk companies.

### Russia.

A New York City shareholder asked what would need to happen for Berkshire to invest in Russia.

> Buffett: Walter Wriston [former CEO of Citibank] said that sovereign governments don't default, but in 1998 he was proven wrong. When we were at Salomon, we were welcomed [in Russia] to drill the holes. They were very friendly until we wanted to take the oil out. It would take quite a while for us to go back. It's hard to develop confidence that the world there has changed in terms of capital, particularly foreign capital.
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>> Comment: Investors who minimize or ignore the risks of hostile actions (including nationalization) by various populist governments do so at their own risk. Individuals contemplating investing money in developing nations should read an international publication like the *Financial Times* or *The Economist* for coverage of events in places like Venezuela and Bolivia. Indeed, some South American countries have a history of confiscating the property of foreign companies. Gullible investors with short memories of nationalization policies remind me of the story about the unsuccessful oilman who died and subsequently arrived at the Pearly Gates. Unfortunately for the oilman, Heaven was full. Taking pity on him, St. Peter decided to see whether he could create some vacancies. In a loud voice he exclaimed, "Oil found in Hell." Sure enough, hundreds of oilmen left Heaven and rushed to Hell. Finally offered a chance to enter Heaven, the recently deceased oilman decided instead to follow the others to Hell, saying, "There might be some truth to that rumor!"

### Berkshire's Cash.

A shareholder from Des Moines said that he has a "two-year rule" for his closet: "If I haven't worn a pair of pants in two years it goes to Goodwill." How about Berkshire's $40 billion in cash?

> Buffett: "It won't go to Goodwill, I can assure you." (laughter) I don't think we'll hit a home run under any circumstances. We need about $10 billion because of our insurance operations—we don't scrape the bottom of the barrel. We reported $37 billion in cash at the end of March 2006. We'd be much happier if we had $10 billion in cash. We have a low probability idea that could take about $15 billion. Business opportunities come at intervals. We don't like having excess cash, but we like even less doing dumb deals. It's likely, but far from certain, that three years from now we'll have significantly less cash and significantly higher earning power. You're right to keep jabbing us on that. We're the biggest player in the catastrophe [insurance] business in the world, and people come to us [because we have great liquidity].
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> Munger: [If you] go back to the Berkshire annual report [of] 10 years ago and compare it to today, you'll see that we have put a lot of good stuff in the company.
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>> Comment: Patience, grasshopper. It's okay for shareholders to ask about Buffett's plans for Berkshire's cash; however, it would be pure folly to pressure Buffett to make more investments. Buffett is the Ted Williams of CEOs—he

has one of the best batting averages when it comes to acquisitions and investments. While he patiently waits for the right pitch, the last thing he needs to hear is his own shareholders shouting, "Swing batter!"

### Coca-Cola.

A Connecticut shareholder asked Buffett to comment on Coca-Cola.

Buffett: "Coke is a fabulous company." The volume sold goes up every year. They have sold about 21 billion cases this year and have accounted for a little greater percentage of worldwide liquid consumption every year. [In 1998] it sold at over $80/share when it earned about $1.50/share. [It generates] fabulous returns on tangible assets. The stock got to a ridiculous level—a wonderful business that sold at silly prices. You can fault me for not selling it. "We like it, and we'll own it 10 years from now."

Comment: Even Ted Williams occasionally struck out. Buffett's human, and he will too. His shareholders and his many fans need to deal with that. Indeed, in any competitive endeavor people need to develop a method to deal with—and learn from—their periodic disappointments and errors. To his credit, Buffett freely admits his mistake in not selling Coca-Cola when it was priced at over 50 times earnings. In his defense, stocks of great companies normally sell at rich prices, and Buffett's time frame for his investments is ***very*** long. (The longer the holding period for an investment, the more long-term operational growth dominates initial valuation as the more important determinant of investment success.) Still, given the unexpected (and inevitable) competitive threats inherent in market economies, 50 times earnings for a large company is pretty high.

### Silver.

An attendee from Frankfurt, Germany asked about Berkshire's holdings in silver and how to value a non-interest bearing asset.

Buffett: We had a lot of silver once, but we don't have it now—and we didn't make much on our prior holdings. One of the drawbacks of commodities is that they sit there [and don't pay dividends].

Munger: "It's a good habit to trumpet your failures and be quiet about your successes."

Comment: I included this question purely to emphasize Munger's comment. Envy may be the silliest of the seven deadly sins, but pride is still the deadliest. (When you hear someone say, "I'll sell when I break even," consider it a sign of pride.) To guard against clinging to foolish pride, I try to heed a comment attributed to the famous economist—and accomplished investor—John Maynard Keynes: "When I'm wrong, I change my mind—what do you do?" That's a good attitude for all investors.

## Share Repurchases.

A shareholder from Texas asked about Berkshire repurchasing its shares.

Buffett: Most of the time we wouldn't be able to repurchase enough Berkshire shares to increase shareholder value. [Buffett showed a chart depicting Berkshire's low share turnover.] The price was compelling when we said we'd repurchase shares [in 2000], but our announcing we'd do it eliminated the opportunity. [If Berkshire's price] gets cheap enough, we'd announce again before buying. Berkshire has low share turnover. We have unusual ownership—the best ownership attitude among shareholders.

Munger: Many repurchases [by other companies] are not to take advantage of a low price but rather to prop up prices.

Buffett: The best example [of a good repurchase] was Teledyne [years ago]. Nowadays, it's done more as a fashionable idea or to try to prop up prices. "We're not looking to buy out our partners at a discount."

> Comment: Since Buffett had his chart prepared before the meeting, he must have anticipated this question. Although he might not agree with my analysis, I think Buffett essentially told everyone that there most likely isn't going to be a Berkshire share repurchase. After all, he committed himself to announcing a repurchase in advance, yet any announcement would likely propel Berkshire's stock price higher than Buffett would pay. Catch-22.

## Advice for Buffett Wannabes.

A Minneapolis shareholder asked for advice for young professionals who want to be like Warren Buffett.

Munger: "The best thing to do is reduce your expectations." (laughter)

Buffett: [Investing] is an interesting business in that much of the activities of investment professionals are self-neutralizing. Most professions have value added—you're better off calling an obstetrician or a plumber, if you need one, than doing it yourself. In the aggregate the investment profession doesn't—and can't [add value]. It's hard to think of another business like that.

The more you charge, at least temporarily, the more you bring in. People have this idea that price equals value—like [expensive] business schools. A lot of that has gotten into the investment field. Large portions of the investment field charge fees that can't be good in the aggregate for investors. You cannot pay 2% [of assets] plus 20% [of gains] and be net better off.

Everyone claims to be the exception. A few will do well. I think I know how to pick a few [money managers], like Bill Ruane [the manager of Sequoia Fund, who died in 2005]. If you know enough about a person—how they've done in the past, about their honesty and character—occasionally you can make a good decision on an investment manager. But not state pension funds—they will choose the best salesman not the best investor.

Munger: "It ought to be a crime to entertain state pension officials."

Comment: Although Buffett didn't use these terms, there are scientific professions and there are competitive professions. In scientific professions like medicine, everyone can be right—or at least everyone can act in accordance with the current state of science. However, in competitive professions like sports, not everyone can win. Indeed, in sports—and investing—above average results necessarily come at the expense of those who underperform. That's why in the aggregate the investing profession can't add value. Nevertheless, some investors can succeed in achieving above average returns, and Buffett said he thought he could identify some of them. He called attention to how investment managers have done in the past, along with their honesty and character. Interestingly, while some observers suggest that past investment performance does not predict future results, Buffett said he would consider past performance. Who's right? It's obvious that past performance doesn't ***guarantee*** future results, yet over the very long run I think investment results do matter. Put differently, anyone with a lick of mathematical sense would have to admit that Buffett's 40+ year record of remarkable investment success almost certainly springs from his superior investment skills. His amazing track record doesn't guarantee future success, but it does provide strong evidence of his investing acumen. In short, long-term track records don't guarantee future results, but they do indicate skill. Anyone can talk a dazzling talk when it comes to investing—and many do—yet only those who are truly skillful stand much chance for meaningful success. I like to say that over the short term, past results may not matter much, but over the long term, only results matter.

Concerning Buffett's remark about paying 2% of assets and 20% of gains, hedge fund investors should take heed. With such heavy expenses, combined with the difficulty all investors face in achieving above-average returns, very few hedge fund shareholders are going to achieve long-term investment success.

### Technology and Competition.

A questioner from Norway asked if the nature of media and entertainment businesses will change permanently and become less predictable due to new technologies and the Internet.

Buffett: People always want to be informed and entertained. As the years have gone by, technology has opened up a vast variety of ways to be informed faster, and [there are] certainly many more modes of delivery. But [there is] no more time for entertainment—we only have two eyes and 24 hours a day. Any time you get more people competing, economics deteriorate. Very few businesses get better [more profitable] with more competition. Generally speaking, the economics of the media business do not have a good outlook. Newspapers have fewer opportunities for earnings streams, though they are still enormously profitable in return on tangible assets. TV still has good margins, but audiences have declined. A government TV license [led to] an enormous revenue stream when there were only three "highways" between Ford, Procter & Gamble, and the eyeballs of millions of people. Now people have lots of alternatives. World Book [a

Berkshire subsidiary] sold for $600 [a set] in the 1980s. We still have a good product, but with the Internet there are lots of alternatives—and [this trend] won't stop.

Munger: It'll be a rare business that doesn't have a way worse future than a past.

> Comment: It is the nature of markets to provide many substitute goods and services when returns on investment are high. Profitability attracts competition like honey attracts bears, and the freer the economy the faster the pace of competitive innovation. Fortunately for consumers, sometimes businesses employ short-term reasoning when they try to achieve a competitive advantage. For example, years ago most gas stations didn't have porticos to shelter customers from the sun and rain. Eventually, some gas station owners reasoned that adding a portico would lure customers from competitors. However, once competitors built their own porticos, no gas station had a competitive advantage—only higher costs. This is an example of what's called the "fallacy of composition." Munger's remark about the future for businesses may seem pretty sweeping at first glance, but history certainly supports his point. Put differently, capitalism is a consumer-friendly system.

## Currency Values and the Current Account Deficit.

Combining two similar questions, a shareholder from New York City asked for Buffett's views on currency values, and a shareholder from Kansas City asked about the current account deficit.

Concerning currency values:

Buffett: My views on currency are as strong as ever—probably stronger. We're doing less with currencies because the carry costs are negative. There are better ways of mitigating the consequences of a devalued dollar. [Now] we like to have earning power in other currencies. The fundamental picture, which in my view is almost certain, is that there's a very high probability of the U.S. currency weakening against other currencies over time, because we are following policies which don't seem to leave much choice. In 2002, Greenspan said that countries with large current account deficits invariably get into trouble, and the current account deficit will have to be restrained. [Back to Buffett:] The current account deficit "is going to lead to something." I think you'll see significant consequences at some point. One consequence is significantly more inflation—it gets tempting to pay back in cheaper currency.

Munger: I don't consider it a big deal. About half of our surplus cash is in non-U.S. currencies. Generally speaking, it can't be good to run a big current account deficit and a big fiscal deficit that are rising. In the end, we'll almost certainly change policies painfully.

Buffett: Yes, painfully. Everybody says it [the current account deficit] is unsustainable, but they don't say how it will change. The longer we're in a [building] net debtor position, the more likely an event occurs in which currency values play a part. We saw portfolio insurance catch on in the 1980s—it was very popular in the academic literature. The small amount of dollars affected/guided by portfolio insurance became the leading factor in a [one day] 22% [stock market] decline. Such mechanistic procedures for accommodating fluctuations, when aggregated and having to follow a given signal, created a doomsday machine on October 19, 1987. The potential for that sort of thing is [now] magnified. When fire is yelled, the currency markets will play a part in the rush for the door.

Concerning the current account deficit:

Buffett: We [Americans] have earned more on [our] assets invested overseas than foreigners got on their investments in the U.S., although that's flipped recently, partly explained by the fact that [Treasury securities] don't yield much. Our net debtor position declines as the dollar weakens.

Munger: "It's amazing how much ruinous behavior you can get away with if you are a successful government." Do you want to invest in Europe, Brazil, Venezuela? It's not totally irrational that investors still like the U.S. despite its problems.

Buffett: I agree with that. If you landed from Mars, you'd still rather land in the U.S. than anywhere else. There's always the potential that when you're doing something dangerous that it can get away from you.

Comment: Buffett's views on currency values garner a lot of press; however, they are well founded in economics. Specifically, if a country consistently runs a significant current account deficit, sooner or later the value of its currency in terms of other currencies will decline. Conversely, if a country consistently runs a significant current account surplus, its currency must eventually appreciate. (Hopefully, Japan, China and others understand this point.) Indeed, one country's deficit and another's surplus are two sides of the same coin. One reason that the U.S. dollar hasn't depreciated relative to the yen, renminbi, etc. is that foreign producers and governments have made it their policy to move mountains to try to keep their currencies from appreciating (which would reduce the relative competitiveness of producers in Japan, China and other countries). Nevertheless, countries running trade surpluses have two alternatives for their accumulated U.S. dollars. First, they can buy U.S. goods and services, thereby reducing or eliminating their surpluses. Second, they can invest in U.S. dollar-denominated assets, such as U.S. stocks, bonds and property. However, investments in dollar-denominated assets ultimately produce yet more dollars, so this can only be a temporary solution. (Temporary or not, as long as foreign consumers don't buy enough American goods to balance trade flows, in the aggregate foreigners ***must*** acquire dollar-denominated assets.) As Munger perceptively pointed out, it makes sense for surplus nations to invest in the U.S.—despite our trade deficit and the likely eventual fall of the dollar—because investing in very weak economies (like France and Germany) or struggling populist economies (like Venezuela and Brazil) may not seem very appealing.

It takes two to tango, and it takes two to have a trade imbalance. I'm not sure whether Buffett would agree with me, but the solution to the U.S. trade deficit requires foreigners to buy more U.S. goods and services just as it requires Americans to cut their consumption of foreign goods. A lower dollar will improve the trade imbalance, so it isn't a bad thing. An excessively rapid decline in the U.S. dollar, however, may prove disruptive to financial markets, especially given the convoluted nature of currency exchange derivatives and such. In short, the U.S. has the strongest economy on the planet, and if the dollar declines gradually, it will be good for the U.S. in the aggregate. If the dollar declines precipitously, there will be accompanying short-term financial disruption. One way or the other, barring an unforeseen change in the U.S. current account, the dollar will eventually decline relative to other currencies.

### Doing Deals.

A shareholder from Iowa City, Iowa asked about Berkshire acquisitions in the past year.

Buffett: One thing we haven't done is participate in auctions. The projections [provided by investment bankers] are just plain silly. Maybe that's why they don't sign those reports—they'd be embarrassed. I'd just love to meet the people who write investment banking books and make them bets as to whether their projections will turn out. I'd make a lot of money.

Munger: Doing deals is not the mindset at Berkshire. There are all these new "helpers" in the world who want to do a deal. That's not our mindset at all—it's totally different at Berkshire. We're looking for partners. We want to build relationships that are lasting and fruitful not only for the owners and us, but the customers. There are so many "deal flippers" out there who are not going to make the money they think. When I asked an ex-investment banker how they made money, he said, "Off the top, bottom, both sides and middle." I think our system is going to work out better [than flipping]. In the end, Omaha [will] do better than Wall Street.

Comment: Buffett and Munger alerted investors to the powerful, self-interested forces promoting mergers and acquisitions. Munger's quote of an investment banker is priceless and should serve as a clear warning about the conflicts of interest in investment banking. Buffett remarked that he'd make a lot of money betting against the accuracy of the typical investment bank's rosy projections. Frankly, I doubt that many investment bankers would be willing to take the other side of the bet. Concerning the gullibility of investment bank clients, I'm reminded of the story told by Charlie Munger about a man who visited a store that sold very fancy fishing lures. "Do fish really go for those gaudy lures?" the man asked. The owner replied, "I don't sell my lures to fish."

### Declining Industries.

A San Diego shareholder asked how to determine a margin of safety in a newspaper company today.

Buffett: What multiple should you pay for a business earning $100 million per year with earnings decreasing by 5% per year, versus a $100 million per year business with earnings increasing 5% per year? Current multiples on newspaper stocks are unattractively high if there's going to be 5% per year erosion—and there's a perception lag in the erosion. Businesses are slow to recognize and adapt to decline—everyone in the business always thinks they see the first robin of spring. It's hard in a declining business to buy things cheap enough. When they take people to the cemetery, they're taking newspaper readers, but when people graduate from high school, we're not gaining newspaper readers. The virtuous cycle [of new readers replacing dying ones] is going in the reverse direction right now. I read five newspapers every day, and I think Charlie reads about the same.

Munger: Four.

Buffett: It shows. (laughter) We thought newspapers were the ultimate bullet-proof franchise, but we were wrong.

Munger: I once thought GM was [bullet-proof] too. GM is just too hard. If something is too hard, we move on to something else. What could be more simple than that?

Buffett: In the 90s, the preprints of the world [e.g., advertising inserts] turned newspapers into a wrapper. There was nothing magical about newspapers except that they got the preprints inside the house. As newspapers lost penetration, it became a less effective way to get information into the house.

> Comment: Buffett noted that it's difficult not to overpay for a declining business, because declining fundamentals eventually may make a mockery of a "bargain" price. Moreover, given the exceedingly competitive environment in market economies, sooner or later most businesses decline. As Buffett and Munger pointed out, newspapers and General Motors once seemed bullet-proof. So did AT&T, IBM, Xerox and Polaroid. As John Templeton once remarked, "Change is the investor's only constant."
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> Concerning Buffett's comment about reading five newspapers a day, I certainly wouldn't argue against investors staying informed. However, while an investor as sophisticated as Buffett knows the difference between real news and sensationalist copy, the average investor should be aware of the risk of investing in sync with newspaper headlines—thereby buying high and selling low. (Bernard Baruch once said, "When good news about the market hits the front page of the *New York Times*, sell.")

## Mentors.

A shareholder from Seattle asked Buffett to provide a few names of present day mentors to look to for advice—the Grahams and Fishers of today.

Buffett: You don't have to look to the present day. You can learn from investing masters of the past—their lessons are timeless. You don't need to look for contemporary investment professionals. Look at Tom Murphy and Don Keough on our board. Investing really isn't complicated. You didn't need to have a high IQ to buy junk bonds in 2002. You needed to have the courage of your convictions and the willingness to do something when everyone else was terrified and paralyzed by indecision. The lesson of following logic over emotion is obvious to some, not to others.

Munger: When Warren and I were young, there weren't many smart people in investing. Now, there are armies of smart young people—a vast amount of smart investment professionals—and you can invest capital at a moment's notice. If there were suddenly a crisis now, there would be many more people looking to take advantage of the situation.

Buffett: In South Korea three years ago you could find many companies in good shape at three times earnings. If you can be wise when everybody else is crazy, you may make some money, but it can be pretty dull in between.

> Comment: Buffett made a very good point. Why search for today's Grahams and Fishers, when the original Graham and Fisher wrote excellent books filled with investment knowledge and insight. After all, investment analysis is not a body of current facts, but a way of thinking. Undoubtedly there are some very fine investors nowadays (including Buffett and Munger), but it's a mistake to think that earlier masters aren't still relevant. With the wide availability of books, articles, lectures and so forth, today's investors are in the enviable position of being able to pick their own mentors. As in any endeavor, if you want to be the best, it's not enough to work very hard. You must study the best who have gone before you.

### Effective Thinking.

A Los Angeles shareholder asked about the importance of having an effective decision making process.

Buffett: Ben Graham said long ago that you aren't right or wrong because people agree with you. The facts determine that. What others are doing means nothing. If something is important but unknowable, forget it. Narrow it down to facts that are both important and knowable. In Chapter Eight of *The Intelligent Investor*, Graham says that the market is there to serve you, not instruct you. Chartists think the market's instructing them. You have to be able to play out your hand in all circumstances—don't be put in the position of playing the other guy's game. Do all these things and you can't miss. Charlie?

Munger: "I'd say some of you can miss." (laughter)

Buffett: "OK, I'll say Charlie can't miss."

> Comment: Graham's statement that "the market is there to serve you, not instruct you" is one of the all-time investment classics. Nevertheless, investors regularly succumb to reading the tea leaves of daily market prices. Indeed, I suspect that if I had a dollar for every time investors tried to use the market for instruction, I'd be as rich as Buffett. What's the cure for letting the market instruct you? Independent thinking. If you do what most other investors are doing, you will settle for mediocre results at best. If you want to achieve above average success as an investor, you must act differently than the masses and you must have a decent batting average. Acting differently stems from independent thinking, and a good batting average comes from careful study.

### Selling Short.

An attendee from Minnesota asked for Buffett's thoughts on illegal naked short selling.

> Buffett: I can't—but I'd love to—lend my Berkshire shares to shorts and get paid to do it. There's nothing illegal about shorting, but it's a very tough way to make a living. Some people on the short—and long—side have done inappropriate things. I don't have a big problem with naked shorting. Situations with great short interest are often, but not always, frauds or semi-frauds. If someone's running something fraudulent or semi-fraudulent, they've probably done it for a while and are probably fairly good at it.
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> Munger: Now you're watching all these happy crooks marching around with your money while you're fielding margin calls!
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> Buffett: I would never put money with a short fund—not for ethical reasons, but because I don't think they'd make money. If you buy a stock at $20, it can go down $20. If you short a stock at $20, it can go up infinitely. It's very tough fiscally and emotionally.
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>> Comment: Over the long run, owning stocks is a positive-sum game. That is, winners win more than losers lose, due to the long-term growth of the U.S. economy. It follows, therefore, that shorting stocks consistently is a negative-sum game—winners win less than losers lose. While hedge funds come in all flavors nowadays, including "long-only" (a seeming oxymoron), the traditional approach to hedging is to own some stocks long and sell others short. Given this mixture of positive-sum and negative-sum strategies, and given the high fees associated with most hedge funds, it's going to be a pretty unusual hedge fund that provides superior long-run returns compared to the S&P 500.

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