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### *The 2004 Berkshire Hathaway Annual Meeting Top 20 Questions*

During the question and answer portion of the 2004 Berkshire Hathaway annual meeting, shareholders asked Warren Buffett and Charlie Munger a total of 53 questions. Most of these questions were interesting, although some were more relevant to investors than others. In order to focus on the most relevant questions and answers, I have selected 20 for closer review. In addition, although Buffett and Munger need no clarification, I thought it would be useful for some readers if I supplemented Buffett's and Munger's answers with some additional comments directed at elaborating on their responses. The ground rules at the Berkshire annual meeting included a ban on recording devices, so the following material is based on my handwritten notes taken over the five hours devoted to questions and answers. Where I have felt sufficiently confident about Buffett's or Munger's exact words, I have used quotation marks — although it is still possible that their exact wording varied slightly from my notes. Where I have paraphrased Buffett or Munger, I have tried to remain close to their wording and faithful to their intent. Nevertheless, I would like to note that neither Buffett nor Munger has reviewed this document, and they do not necessarily endorse my summaries of their remarks or my comments.

#### **What should an investor do during inflationary times?**

A shareholder from Athens, Greece asked for advice concerning how to preserve one's purchasing power in an inflationary environment. Buffett's first response was, "The best thing is to have a lot of earning power of your own." He added that it also makes sense to "own fine businesses that can price [their products or services] in inflationary terms." He cited See's Candies, a long-time Berkshire company, as an example of such a business, but noted that many companies wouldn't do well in inflationary times, because they would need to make significant expenditures to buy (increasingly expensive) capital equipment.

**Comment:** The employment value of one's skills is a natural inflation hedge, because salaries are based on inflated dollars. Given the considerable value of one's employable skills (derived in part from the investment of time and effort involved in acquiring them), it stands to reason that they should be considered a part of one's portfolio of assets. Nevertheless, many investors tend to ignore (or under-appreciate) the degree to which their own skills can represent significant financial value. Indeed, a 40 or 50-year-old who earns \$50,000 a year 'owns' the equivalent of a conservatively invested six-figure financial portfolio. Similarly, one whose skills command \$100,000 a year may be deemed to own the equivalent of a seven-figure financial portfolio. In short, there can be significant value in one's skills, and it is realized by exchanging one's work for compensation. In financial terms, the decision to retire early is

an aggressive one — that is, it involves relinquishing the income stream from a significant asset (one's skills), thus placing greater pressure on one's investment portfolio to perform. Early retirement may also limit the risk appropriate for one's financial portfolio, thus limiting its return also.

### **Asset allocation.**

A Nebraska shareholder asked Buffett how he went about determining and prioritizing the various classes of assets that would be appropriate investments for Berkshire. In a separate question, a shareholder from Los Angeles noted that financial planners and Wall Street brokerages charge a lot for 'asset allocation' models. He asked Buffett to explain how he used price and value, instead of mathematically based financial models, to allocate capital.

Buffett and Munger noted that at Berkshire, there is no checklist of prioritized asset classes or ideas. All investments are simply alternatives to each other. Buffett added that the "typical stuff [of asset allocation] is pure nonsense." He criticized the practice of brokers and financial advisers recommending that investors hold a given mixture of stocks and bonds, saying "typical asset allocation is just merchandising — you don't need this." Instead, he suggested, "The best way to reduce risk is to think." The default position for investors should be short-term instruments, he said, and investors should move into longer term investments only when it's justified. In Berkshire's case, for example, during the summer and fall of 2002 junk bonds fell to such low prices (some offering 35-40% annualized yields-to-maturity) that Buffett and Munger felt the opportunities in junk bonds were "screaming at us." Therefore, Berkshire acquired junk bonds during 2002, although Buffett noted that these bonds rose in price soon thereafter and, thus, became significantly less attractive. Referring to the issue of asset allocation (as it is marketed to individuals), Munger added that "the poor guy in the public is getting a poor deal from the 'experts' — it's disgusting."

**Comment:** Investors should heed Buffett's and Munger's blunt comments. Most of the asset allocation plans that I've seen are based on assumed rates of return (for various assets) and, very importantly, the relative correlations between various asset prices. Rates of return and price correlations, in turn, are typically based on historical data. However, the historical data on price correlation coefficients is anything but stable. (For example, at times in the past stock and bond prices have been positively correlated, yet at other times they have been negatively correlated.) Moreover, future price correlations (between asset classes) are just not predictable. It is simply not possible to devise an appropriate asset allocation plan without having a good grasp of future returns and price correlations. Thus, as Buffett noted, intelligent thinking and analysis will likely lead to a more accurate assessment of risks and returns than the use of typical asset allocation plans and their rather arbitrary assumptions.

### **Determining investment values.**

A shareholder from New Jersey asked how Buffett evaluates the business value of growing companies, especially when a company's growth rate is greater than the 'discount' rate (used to adjust future earnings to present values).

Buffett replied that, mathematically, if a company's sustainable growth rate exceeds the discount rate, business value computes as infinite. However, he noted that "it gets very dangerous to project high growth," and that "projecting extremely high growth rates for very long times has lost a lot of investors a lot of money."

**Comment:** When a mathematical analysis suggests that a business has infinite value, you'd better check both the math and your assumptions, because one of these is wrong — and it's usually not the math. Projecting corporate growth that continually exceeds the discount rate is similar to projecting a company's growth to always exceed the growth of the economy within which it operates. (Any company that continually grows faster than the overall economy would eventually be larger than the economy itself, which makes no sense.) In reality, competition between companies makes it extremely difficult for companies to sustain high growth. Indeed, history is quite clear — it is exceedingly rare for companies to maintain high growth over many years. Thus, investors should be cautious when considering high price/earnings (P/E) stocks, because high P/Es typically require extended periods of high corporate growth to justify current prices, let alone higher prices.

### **Studying investments.**

A questioner from Vienna, Austria asked Buffett what publications he read to get investment ideas and how he devoted time to studying investments when he was younger.

Concerning the approach he took to educating himself in investing, Buffett replied, "If I had to do it over, I would do it the same way." He remarked that he and Munger looked at everything in sight they thought they could understand, and he noted that if they could go back to when they were younger, "we'd have an enormous advantage to be working with much less money." Munger added that an investor needs to have a temperament that "grabs the best ideas," adding that such a temperament is rare. Buffett agreed that an investor's temperament is very important and, put differently, investors need a "business mind." He emphasized that one doesn't need an extraordinary intellect, but does need "extraordinary discipline." (As an example of what can happen to someone with an extraordinary intellect, Buffett noted that Isaac Newton lost a lot of money in the South Seas Bubble.)

**Comment:** Although Berkshire's current size suggests that most of its best years (in terms of percentage growth) are behind it, it's a tribute to Buffett's abilities as an investor that he has done so well in recent years — even as Berkshire's assets have grown to dozens of billions of dollars. In many businesses, success breeds further success; however, in money management, success — and the money it attracts — tends to create a drag toward mediocrity. It is a testament to Buffett and Munger's skills that they have managed so much money so well for so long.

## **Math is the language of God.**

A shareholder from Germany asked for comments about the (unattributed) assertion that ‘math is the language of God.’

Munger replied, “It’s as if God made the world so that only those who understood math could succeed — it’s just that way.” However, he qualified his remarks by stating, “You don’t need to know high math — which may actually be a hindrance.”

***Comment:*** Munger makes two important points, in my view. First, intelligent investing requires some fluency in the basic concepts of compound growth, time value of money, discounting, etc. If you aren’t familiar with these concepts, then you should either take the steps necessary to learn the math or leave investing to those who do. Second, higher math may well prove to be much less useful than expected — it can even become counterproductive. When investors rely on mathematical analyses that lack sufficient economic justification for the underlying assumptions, the results may be especially dangerous. Many of the mathematical investing analyses that I’ve seen seem to fundamentally misconstrue the nature of risk and, frankly, they seem to be more aimed at overwhelming the uninitiated than providing a meaningful understanding of investment risks and returns. Indeed, two of the greatest financial fiascoes of modern times — the calamitous use of ‘portfolio insurance’ in 1987 and the collapse of the Long Term Capital Management hedge fund in 1998 — were brought to us by people who were more familiar with higher math than with economic reality.

## **Regrets.**

A questioner from Minneapolis asked Buffett about the importance of learning from history and what he regretted the most.

Buffett replied that he regretted having given up on his plan to buy 100 million shares of Wal-Mart simply because the stock’s price began to rise (slightly) after he started buying. (He referred to his behavior as being “anchored to a price.”) He calculated that his failure to continue buying Wal-Mart — a company he clearly understood and admired — cost Berkshire shareholders approximately \$10 billion. Although on a smaller scale, Buffett noted that there were other examples of his “thumb sucking” that involved opportunity costs to Berkshire shareholders. He and Munger acknowledged that mistakes (both of omission and commission) are an inevitable part of investing, and that they tried to learn from theirs. “We rub our noses in our mistakes,” said Munger.

***Comment:*** Buffett never purchased Microsoft, either. However, while Wal-Mart was a company he admired and understood, Microsoft was outside his circle of competence. Thus, he’s kicking himself for failing to buy Wal-Mart, but not Microsoft. Frankly, I think Buffett is being too hard on himself. Valuing growing companies, especially rapidly growing companies (like Wal-Mart), is one of the hardest things an investor can attempt, because significant differences in the ‘correct’ value can be caused by slight differences in growth projections (over a long period). Further, since long-term rapid growth is so rare, investors must be careful in paying up for

companies with a great deal of promise. Indeed, to be fair, while Buffett's error of omission in not buying Wal-Mart amounted to a sizeable opportunity cost (in hindsight), his conservative approach to investing has probably saved Berkshire shareholders from a number of potentially costly errors of commission.

### **Finding good investment managers.**

A shareholder from Massachusetts asked, "How do you choose investment advisers or managers?"

Buffett remarked that it is hard to find good, honest advisers. Indeed, when he dissolved his investment partnership in the late 1960s, he could find only two managers to recommend to his former partners. Munger added, "You are unlikely to find in your lifetime many people who are capable." (Digressing slightly, he also noted that "the idea that you should have widely diversified portfolios is madness.") According to Buffett, "how a manager accomplishes results is important [and] promotional types are not likely to meet [the] tests of ability and integrity." Munger and Buffett went on to address the subject of mutual fund investment managers, with Munger noting that some of these managers essentially "accepted bribes to betray their shareholders." Buffett commented that within the mutual fund industry, "there had to be hundreds of people who had to be aware of this [the recent scandals] — hundreds of people who never said a word."

***Comment:*** The best way to find a good investment manager is to solicit opinions from knowledgeable investors who have no financial stake in their recommendations. (The key words being 'knowledgeable' and 'no financial stake.')

Our firm does not provide compensation for referrals, yet I think most investors would be shocked to know the extent to which compensated referrals occur in the investment and related industries.

### **Corporate profitability.**

A questioner from North Carolina asked Buffett whether he thought the stability of corporate profitability would change, given management concepts like EVA (economic value added), advances in technology and inventory control methods.

Buffett said he didn't think so. He noted that corporate profitability "will bob around, but corporate profits as a percentage of GDP won't change." He added that there were "a lot of self-neutralizing factors in capitalism." He related an example from the early days of Berkshire (when it still owned a textile operation). Although Berkshire bought new equipment to increase productivity, so did its textile competitors — and due to stiff competition between firms, no company experienced an increase in profitability. (In short, more efficient production methods simply lowered textile prices). Buffett said that technology can increase or decrease a given company's profitability, and that consumers, not businesses, are the primary beneficiaries when corporations use technology.

***Comment:*** In the final analysis, capitalism is decidedly pro-consumer. As companies attempt to increase their own profitability, they make use of technology and production methods that lower costs. However, frequently these lower costs are simply passed on to consumers, because competitors are

also pursuing lower costs. (The failure to correctly anticipate pricing and profitability results, when numerous competitors take similar actions, is an example of the ‘fallacy of composition.’)

### **Business valuation.**

A shareholder from Melbourne, Australia asked Buffett how he estimates future business value, while incorporating a margin of safety.

Buffett replied that he “calculates the variables [in the business valuation process] conservatively and then applies an overall margin of safety.” He noted that Benjamin Graham often used “net working capital” as a useful measure, but “that method ran out of steam.” Buffett then used earthquake insurance to illustrate the process of using conservative estimates and then applying a margin of safety. He said that there have been approximately 26 California earthquakes of 6.0 magnitude over the last 100 years. If he were to attempt to price earthquake insurance, he might estimate the frequency of earthquakes at 30 or 32 [that’s the conservative assumption part] and then price the insurance with a margin of safety. He also noted that it wouldn’t make sense to use an ultra-conservative earthquake estimate of, say, 50 earthquakes in 100 years, because then “you wouldn’t write any insurance.”

*Comment:* Concerning Graham’s ‘net working capital’ approach, in the aftermath of the Great Depression, Graham was able to find a number of stocks selling at what would now seem to be ludicrously low prices (i.e., at less than the per-share value of current assets minus all liabilities). However, these sorts of bargains aren’t normally available nowadays. In Buffett’s earthquake insurance example, note that he was careful to avoid both unrealistic optimism and unrealistic caution. Investors who focus on looking for investments that are too good to be true, will often find just that.

### **Investment recommendations.**

A questioner from California asked Buffett whether he would recommend an index fund or Berkshire stock.

Buffett responded that “we never recommend Berkshire.” He also stated that “a low-cost index fund will do better than 90% of the people around you,” especially if one’s money is put to work over a period of years. Munger added that “it’s awkward [to say that] when so many stock brokers who have done so well and honorably attend our meeting, but the majority of brokers will underperform an index fund.”

*Comment:* Obviously, Buffett’s “90% of people around you” remark wasn’t meant to apply to the Berkshire Hathaway shareholders in the auditorium, since Berkshire’s long-term results have exceeded virtually all index funds. Although some might disagree with the 90% number (thinking it’s too high), there is no doubt that only a minority of investors have beaten the S&P 500 index over the long term (say, ten or more years). However, among those, like Buffett, who have successfully beaten the S&P 500, it is interesting to note that many have incorporated the classic Benjamin Graham, Phil Fisher,

Warren Buffett, Charlie Munger approach of thinking independently, employing careful research and incorporating a margin of safety.

### **Catastrophes.**

A shareholder from Boston asked Buffett for his thoughts on the possibility of a major ('transformative') catastrophe in the next 50 years.

Buffett replied that "people tend to underestimate low probability events when they haven't happened recently, and they tend to overestimate low probability events when they have happened recently." He noted that it was his nature (and Munger's) to think about low probability events, and that a 'transformative' catastrophe is less likely to come from natural causes (earthquakes, etc.) than from man-made causes, especially in financial markets. He also noted that "almost anything can happen in financial markets...[but] the only way really smart people can get clobbered is through the use of leverage...[because leverage] can keep you from playing out your hand." Buffett added that, unlike some hedge funds, "we just don't believe in lots of [financial] leverage." A financial calamity may be painful for those affected by it, but it can also provide opportunities for others. Buffett noted that "Wall Street is awash in high IQ talent, yet extraordinary things [in financial markets] happen." He noted that in 2002, when junk bond prices fell to ridiculous levels (and represented amazing bargains), some of the high-IQ Wall Street types wouldn't buy them; yet now, when they are much more expensive, these same people are buying.

***Comment:*** People frequently place too much emphasis on recent events. Put differently, the economic and investment situation is seldom as good as it appears after a long run up in prices, and it is seldom as gloomy as people fear after a long decline in prices. Experienced investors understand — and take advantage of — the tendency of inexperienced investors to extrapolate recent events. One of the dangers when investors use margin is that although they may have a correct long-term outlook, they may be forced — by margin calls — to sell their investments before they have had sufficient time to work out. Indeed, in the depths of a bear market — when margin calls are legion and prices spike downward from forced selling — some of the best investment opportunities can come from buying the forced liquidations of excessively leveraged investors.

### **Corporate integrity.**

A questioner from Boston asked how an entry level company employee could find out if her employer operates with integrity and with the long-term interests of shareholders and employees in mind.

Buffett paused for a moment and then said, "I have no good answer . . . it's very easy to be fooled." He suggested that an employee "be suspicious of companies that place a lot of emphasis on the price of [their] stock — like [displaying it] in the lobby," although he noted that he "doesn't look at this [concern] by itself." He also noted that it may be possible to pick up some relevant observations from co-workers. Munger mentioned that assessing management is "easy when you have some caricature like Bernie Ebbers or

Ken Lay, but I wouldn't have thought it at Royal Dutch [Shell]." Buffett agreed that he wouldn't have spotted it at Royal Dutch, either.

Expanding on the subject of governance, Buffett noted that "what happened in the 1990s was an 'anything goes' feeling — situational ethics took over." Unfortunately, he added, "you sink faster than you rise [in regard to ethics]." Moving on to the issue of expensing corporate stock options, Buffett said that "it was a disgrace when the U.S. Senate threatened the [Financial] Accounting Standards Board with extinction" for proposing the expensing of options during the 1990s. Buffett added that "the defeat of this proposal seemed to signal that it was more important to have stock prices rise than to tell the truth."

Buffett invited the audience to go to Google and type "Indiana" and "pi" (the mathematical term) in the search box. [So much for reports that Buffett uses the internet only to play bridge.] He said one would find stories about how the Indiana House of Representatives voted almost unanimously to legislate a new value for pi. Remarkably foolish as that may seem, Buffett went on to say that "the U.S. Senate cleansed the [record of the] Indiana House by outdoing them — Senators were willing to declare the world flat." Munger added that "these people [the U.S. Senate] were way worse, because the Indiana House was stupid, while these guys were dishonorable."

**Comment:** If it's hard for sophisticated investors like Buffett and Munger to spot lapses of corporate integrity, then it's going to be even harder for an entry level employee (or most investors) to do the same. As to the issue of expensing options, in 2004 the Financial Accounting Standards Board is again trying to address this issue, and some members of Congress are again trying their best to thwart accounting reform. If those who claim that it's unrealistic to tell the truth in financial statements again hold sway (the outcome has not been determined as of this writing), it will be a dark day for investors.

## **Incentives.**

A questioner from New Jersey asked whether Berkshire had adjusted its internal incentives so that it did not write bad insurance business.

Buffett gave a brief history of how Berkshire came to own National Indemnity, one of its insurance subsidiaries, and then noted, "If you offer a silly price [selling insurance], brokers will find you in the middle of the ocean at 4:00 a.m." Emphasizing the importance of not writing insurance business when prices are too low, Buffett added that "we can take an expense ratio that's out of line [due to a low level of underwriting], but we can't stand underwriting bad business." Addressing incentives, he said that Berkshire's underwriters and sales people "know that they'll never be laid off due to a lack of volume." (He acknowledged that "you can't run an auto or steel company that way.") Buffett pointed out that National Indemnity has had no special advantages over the years, except "they had discipline."

**Comment:** Interestingly, Buffett came prepared with a series of slides addressing the history of National Indemnity's operations — yet nobody thought to ask him whether he had prepared any other slides for potential



questions. I think that one key point to take away from Buffett's discussion of Berkshire's internal incentives and discipline is this — it's vital to understand that most businesses do not grow at the steady rates that Wall Street seems to expect. Businesses that set out to record steady growth in revenues and earnings will, sooner or later, do something stupid — costing their shareholders dearly. On the other hand, businesses that are managed to grow when the right opportunities present themselves are much more likely to create enduring shareholder value.

### **Dividends versus stock buy backs.**

A shareholder from St. Louis asked Buffett to discuss the considerations involved when public companies have cash that can be used to pay dividends or buy back stock.

Buffett responded, "If a stock can be bought for well below business value, that's the best thing to do." However, he added, nowadays "it's often done to try to support the stock price — at prices that don't make sense for current shareholders." As to Berkshire's currently large cash position, Buffett said, "We have a reasonable expectation that we'll be able to use it."

*Comment:* In Berkshire's 1999 Annual Report (published in March of 2000), Buffett stated that he was seriously thinking about repurchasing Berkshire shares at prices below \$45,000; however, he first wanted to put other shareholders on notice of his intentions. Of course, the mere mention by Buffett of a share buy back was enough to send Berkshire's stock price higher, and the contemplated stock buy back never happened. Based on growth in Berkshire's book value since the end of 1999, the \$45,000 price at the time of Buffett's buy back remarks would correspond to a price of approximately \$60,000 in 2004. (This exercise addresses a potential buy back price, not Buffett's idea of Berkshire's intrinsic value.) Buffett's point about other companies buying back over-priced stock is an important one. Although some shareholders seem to think that all stock buy backs are good, when a company's funds (i.e., the shareholders' money) are used to purchase anything that's not attractively priced, including the company's stock, shareholders will ultimately suffer. There is a natural reluctance on the part of many companies to pay dividends, because money paid in dividends isn't available to enlarge managements' empires. While Berkshire has never paid a dividend, Buffett's record of wisely employing his shareholders' funds speaks for itself — thus, most shareholders are willing to cut Mr. Buffett some slack concerning dividends.

### **Phil Fisher.**

A shareholder from Mississippi wanted to know whether the work of Phil Fisher (who recently died) had guided Buffett in his investment approach.

Buffett said that "Phil was a great man," and "as with Graham, you could get it all through their books." He said he met Fisher only once, in 1961 or 1962. Buffett added that he had met Charlie Munger (who, like Fisher, has emphasized a focus on exceptional investments) in 1959.

**Comment:** Given Buffett's tendency to concentrate on exceptional investment opportunities (an approach seemingly closer to Fisher's than Benjamin Graham's), I was a bit surprised to learn that Buffett had met Fisher only once. I could be wrong here, but although Buffett's comments about Fisher were most respectful, I sensed that in addition to emphasizing the usefulness and completeness of Fisher's writings, Buffett also wanted to give Charlie Munger credit for his influence on Buffett's investment style.

### **Initial public offerings (IPOs).**

A shareholder from Sydney, Australia (who proclaimed that it was great to be in the 'second best country in the world') asked Buffett and Munger for their thoughts on initial public offerings.

Munger said, "You can use our mental models to evaluate IPOs or other investments — but the average person buying IPOs is going to get creamed." Buffett noted that "an auction market [such as the stock market] will occasionally offer a great deal, but with IPOs — which is more of a negotiated sale — the seller rarely decides to sell at a very low price."

**Comment:** While it is true that IPOs are sometimes underpriced, based only on the very short-term demand for the offering (the underwriters want to move the merchandise), individual investors rarely have the opportunity to acquire a meaningful stake in hot IPOs. Further, once the initial frenzy has passed (sometimes as early as the first day of trading), IPOs tend not to perform very well. (Moreover, not all IPOs are 'hot.')

In general, if offered the chance to purchase an IPO, I'd suggest that investors heed the Wall Street maxim which states that if you can't get shares of an IPO, then you should want them — but if you can get them, you shouldn't want them.

### **A troubled world?**

The next questioner, from Saint Louis, claimed to have spoken with a former manager of a large Fidelity mutual fund, who purportedly emphasized a number of troubles in the world. The questioner then asked Buffett for his outlook for the next 5 – 10 years.

Buffett noted, "You can always find negative factors — even in 1974, when there were great stock bargains." He said, "We pay no attention to this stuff [because] our underlying premise is that this country will do very well — and well for business." Buffett added that "Charlie and I have never passed on a great opportunity due to external conditions." Further, he said, "It won't be the U.S. economy that does investors in — it will be investors themselves."

**Comment:** I was born in the late 1940s. In my lifetime there have been wars involving significant numbers of U.S. troops in Korea, Vietnam, and the Persian Gulf (twice). In addition, there have been numerous smaller conflicts and, importantly, a protracted Cold War that devoured untold billions of dollars over a 40-year period. One U.S. president was assassinated, another was forced to resign and another was impeached. There have been periods of low inflation and high inflation, low interest rates and high interest rates.

There was a one-day stock market crash of over 20% (on October 19, 1987) and a prolonged market decline from 1969 to 1974 that, adjusted for inflation, was as steep as the decline of 1929 – 1932. There have been 10 recessions (some steep) and numerous bear markets. There was a close brush with nuclear Armageddon during the Cuban Missile Crisis of 1962, an oil embargo in 1973, chronic strikes by labor unions during the 1970s, riots in major city streets in the 1960s and 1970s, and numerous other economic, political and social upheavals. All in all, the world is simply not a placid place. However, throughout these decades, economic growth — driven primarily by advances in science, medicine and business methods — has continued. As Buffett said, investors have more to fear from their own behavior than from an ever-changing world.

### **Hedge funds.**

A shareholder from Mexico City asked whether individual investors should consider investing in hedge funds.

Buffett replied, “I’d say that people currently invested in hedge funds will be disappointed.” Concerning the current popularity of hedge funds, Buffett added, “There are fads on Wall Street, which will sell what it can sell.” He noted that “hedge funds are distinguished not by [their managers’] abilities, but by their ability to charge high fees — you don’t get smarter by running a hedge fund.” In view of hedge funds charging money management fees plus part of their portfolios’ profits, Munger jokingly added that “if a second layer of fees is better than one, wouldn’t a third layer be better than two?” Implying that many hedge fund fee structures were unfair to their shareholders, Munger remarked, “I think it’s a mistake to get in with people who propose unfair transactions.” Concerning the ‘funds of (hedge) funds’ concept, Buffett pointed out that there is a “piling on layer over layer of costs.”

**Comment:** Notice how many questions came from international shareholders? Buffett’s appeal is worldwide, because his investing philosophy is rooted in the universal language of logic. Concerning hedge funds, it is not uncommon for them to charge 1 – 2% annual management fees plus 10 – 20% of investment gains. That is a formidable amount of cost to overcome. In addition, although information about hedge funds is often limited (many are not registered with the SEC), there have been persistent claims that hedge funds participate in a variety of illegal or unethical behaviors. For example, the first settlement in the recent scandal concerning late trading of mutual funds involved a hedge fund — as the investor doing the late trading. Further accusations involve attempts to manipulate marketplace prices (in violation of the Securities Exchange Act of 1934) and the creation and spreading of false rumors in order to take advantage of misinformed or frightened investors. Whether these accusations are true or not (a number of observers suspect that they are valid), the investment track records of some hedge funds leave much to be desired in terms of completeness, comparability and objectivity. Specifically, not all hedge funds report their results, these funds frequently use significant amounts of leverage (review Buffett’s comments on leverage), the life spans of some

hedge funds are short, and reported results are not always corroborated by an independent third party.

### **Investing principles.**

A questioner from Washington, DC asked Buffett what ‘habits’ have contributed to his learning.

Buffett noted that he hasn’t had to continue learning basic investing principles, because these principles have stayed the same since Benjamin Graham wrote about them. Munger added that “basic principles are not enough alone — you do have to learn.” Buffett agreed and added that “an investor’s temperament is most important — but not sufficient [by itself].” In describing the thought process of successful investors, Buffett noted that good (human) chess players “instantly eliminate 99% of possible [poor] moves”— unlike chess playing computers, which iterate through nearly every possible combination of moves.

**Comment:** Computers play chess by systematically analyzing many thousands of possible move combinations and looking for the best outcomes, whereas humans necessarily select a relatively few possibilities to analyze. For the game of bridge, however, computer programmers have been forced to try to simulate human evaluation methods, because the number of move combinations in bridge is many times greater than in chess — and computers don’t currently have the ability to iterate through such a large number of combinations in a reasonable amount of time. All in all, computers play excellent chess, but terrible bridge — precisely because they cannot and do not ‘think’ like humans. (Indeed, they don’t think at all.) In the game of investing, the number of factors to consider is many times greater than in bridge and, as a result, computers have not made for very good investors. There are well over 10,000 publicly held companies in the U.S. alone. It would be impossible for any investor to carefully analyze more than a small fraction of all such companies, so it is indeed imperative for investors to limit the number of investment possibilities that they choose for detailed research. The limiting process is part of what Buffett refers to as an ‘investment temperament,’ and it is something that takes time and practice to develop. Interested readers can turn to our investment book reviews as a good starting point to acquire the best investment skills and temperament.

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