

## Long-term Investing

*It's alive and well in Omaha*

**(Printer ink warning --- this is a long one)**

I've thrown away a couple summaries of last weekend's Berkshire Hathaway meeting since they seemed stale and boring. Then my son Spencer came to the rescue---this was his first Berkshire meeting and his notes turned out to be more interesting than mine. They are presented in their entirety at the bottom of this email. The kid might have a future.

For those who would rather not wade through the entire list of questions and answers I recommend looking at the following five as the most interesting: 4, 12, 18, 36, 42.

The primary idea you get when listening to these two (Warren Buffett and Charlie Munger) is that even at ages 78 and 85, they continue to look at investing as a long-term project and they remain optimistic about the future. Maybe that's why they seem younger than their published ages.

We've been busy putting cash back into stocks. There seems to be so much idle cash right now that the market is not being allowed to correct. Of course that could change this afternoon, but the list of very smart bearish investors who are turning bullish continues to lengthen and the list of economic indicators pointing to either stabilization or actual recovery gets longer every day.

April was a spectacular month in the market and our portfolios lead us to think we are on the right track in our efforts to repair the damage inflicted in 2008. Stay tuned.

Best regards,



Daniel A. Ogden

## Berkshire Hathaway Annual Meeting

May 2, 2009

35,000 in attendance

5,000 questions submitted

51 Questions answered

### **Best Exchange:**

**WB:** I'm no good at predicting currencies.

**CM:** You did OK last year.

**WB:** Well, we did make a couple of billion. (chuckles)

### Short-Term

Sees Real Estate stability at lower prices.

1.3 million new households a year, clearly 2 million housing starts at the peak was unsustainable,

1.5 million inventory of unsold homes

400,000 housing starts now

1-2 year inventory to work through before starts and prices pick up.

In areas with less of a boom, like Omaha, would buy today---Charlie Munger.

Real estate is fragmented, and some areas, such as south FL, will be in trouble for a long time.

Retail has seen a substantial shift in consumer behavior---retail real estate (malls and strip centers) will be in trouble for 2-3 years.

### Long-Term

China has the correct policies in place to unleash a tremendous amount of productivity from 1.3 billion motivated people.

Solar energy has great potential in the coming decades. Charlie Munger, "If you have enough energy you can solve a lot of your other problems."

### Questions & Answers

1) *You referred to derivatives as Weapons of Mass Destruction in the past. Now I feel like Slim Pickens in Dr. Strangelove, riding a derivative bomb down. Were the derivatives trades appropriate?*

**Warren Buffet:** Positions only require 1% collateral, and gives Berkshire the use of \$4.9 billion of many years from just the equity puts. I believe in the long term value of the contracts, and am not concerned with the accounting affects on earnings. With investment gains, the high yield CDS will hopefully break even or at a slight loss. Some of the equity contracts recently had their term shortened by 8 years in return for reducing the strike from 1514 to 994.

2) *How can we improve education to improve financial literacy for future generations?*

**WB:** I think this generation has a problem with financial literacy! I've been involved in recent projects with ABC to teach financial literacy using characters like Elmo, etc. Tells a story about travelling to Las Vegas for the first time in 1950s. He realized that America was a country with many well dressed, apparently wealthy people, travelling many miles, to do something inherently stupid (gamble). Realized that there were many opportunities to make a lot of money (from these well dressed gamblers).

3) *Comments on government programs, Wells Fargo and TARP*

**Charlie Munger:** Government was reacting to a huge crisis last fall, and made good faith efforts, perfection is too high a standard. That said, the accounting rule which allows booking profits by writing down a companies own debt (see Citi's Q1 earnings) is insane.

**WB:** Huge crisis. The flows out of money market funds were unprecedented, and put huge pressures on businesses short term funding requirements. Execs told to

report to Washington DC, told that they must accept TARP money for good of country, and given 1 hour to deliberate, with out consulting others in their firms. Wells Fargo declined. Read Jamie Dimon's letter [here](#).

4) *Value investing as taught usually revolves around Free Cash Flow projections going out 10 years with a terminal value. But you (Warren) have professed to not using calculators or computers in the past. Do you have any tip or tricks to perform this analysis without calculations, and could you use Coca-Cola as an example?*

**WB:** There are three questions in regards to future cash flows: How much, How sure, and When. The old bird in hand parable. If you need a calculator, it is not obvious enough, and the investment shouldn't be made.

**CM:** The worst decisions are often made with the most formal projections. They look so professional that you begin to believe the numbers are reality. You are taken in by the false precision. Business school teaches this stuff because they have to teach something. Aesop doesn't get tenure, formulas do.

5) *BRK investment in Moody's – Given the role of ratings in the crisis, conflicts of interest, the reliance on historical risk models, and with the many regulatory changes coming, why maintain the position?*

**WB:** Doesn't think conflicts of interest were a big problem with the ratings agencies. The real problem was the assumption that housing always went up. A major error that was shared by many. If they had been harsher in their treatment of Real Estate derivatives, they would have been called "un-American" for standing in the way of the American Dream. He did not use his position as an investor to influence practices at Moody's, because that is not how he operates and it hasn't worked well in the past. Believes that the ratings business is still a good one. The ratings are needed, there are very few players. That said, we don't pay attention to ratings, since we don't believe in outsourcing investment decisions.

**CM:** Many investors and analysts sought simplifying assumptions so that they could use complex models.

**WB:** The irony is that many of the creators of these toxic assets ended up holding them. It's like they mixed up the Kool-Aid and then drank it. With BRK managers, the one excuse that doesn't work is that "Everyone else is doing it."

6) *Where do you see California Real Estate going in 1-2 years?*

**WB:** CA is a very diverse market. But in Southern CA where we have Orange County Bank, there has been a pickup in activity at lower price levels, leading to price stability. Of course the main problem is that housing is a fragmented market. You can move a house to where it is needed. Math: 1.3 million new households each year (go get married for the economy!); at the peak there were 2 million housing starts, clearly unsustainable; We are now down to, and may stabilize at about 500,000 starts; with an inventory of about 1.5 million in excess housing units, we can expect housing to remain depressed for 2 or so years. But recovery will be very uneven, with parts of CA and FL being in trouble for a very long time.

**CM:** In areas without a boom (like Omaha I guess), CM would buy today.

**WB:** There will be plenty of activity. There are 80 million households, 55 million mortgages, and nearly 4.5 million sales a year. The market will remain active, but prices and starts will remain suppressed.

7) *You've mentioned that there are 4 potential successors for the investment role at BRK. How did they do in 2008?*

**WB:** Unlike the CEO role, there is no rush with the investment candidates. The portfolio does not need tending in the event that I die tonight. All 4 of the managers were down similar to the market. We are not interested in one year returns, and we wouldn't be interested in someone who went to cash in 2007. We aren't looking for timers.

**CM:** Yes, they (Market Timers) aren't dumb enough for us.

8) *What is the likelihood of Nationalized Health Care, and what would be its impact on BRK?*

**CM:** Something like European Health Care will come, with public competing with private insurance. I wish it could be put off until after the present crisis. I'm not concerned with the impact on BRK.

9) *The 3 CEO candidates, why not bring in the successor now for grooming?*

**WB:** The candidates are out there operating businesses and learning. They have already proven themselves by running successful companies, and couldn't learn any better by hanging out with me all day watching me read magazines. The toughest part for the new managers will be building relationships with BRK managers and investors.

**CM:** It's better to learn by experience than by personal contact. BRK has a very decentralized structure, and the key for the successor will be respecting that and perpetuating it. Believes in cultivating talent internally.

10) *How can we teach young value investors?*

**WB:** If I was running a business school I would have two classes: One, How to value a business; Two, How to think about markets. Remember that accounting is just a tool, don't be limited by its intricacies. Remember the market is there to serve you. It's not about intelligence, it's about a type of emotional stability, and I'm not sure that can be taught. It's simple, but not easy.

**CM:** The problem with educating investors is that no matter how well you do, 50% will still be below the median. Emotional makeup is more important than skill.

11) *WB said "Own a business that can be run by a fool, because someday a fool will run it." Ajit (Head of Reinsurance) runs a complex business, how do you find a successor?*

**WB:** We don't. Ajit is given a very long leash to run the business, and in his absence, risk would be taken way down.

12) *How do you view BRK valuation? How do you react to BRK investments being down 13% in 2008, earnings down only 4%, and yet the stock dropped 30%.*

**WB:** That is a good way to split up the value of BRK. However, the benefit of insurance is not its value, or prospect of future profit. We view insurance as a break even investment, and do not expect positive cash flows over the long term. Insurance gives us float, and our other subsidiaries and investments provide the opportunity to invest that float. There was a very drastic, rapid change in consumer behavior in Sept 2008. BRK subsidiaries involved in retail and housing were very hurt, and will be for a long time. Luckily, people are interested in saving money, and as such Geico nearly double the number of policies in Q1 2009, and is now the 3<sup>rd</sup> largest auto insurer.

13) *Dividend policy. Are retained earnings still working? It appears that retained earnings have not produced gains in the last 5 years.*

**WB:** He's right; earnings have not produced wealth in the last 5 years. But I believe that our large cash balances have allowed us to take advantage of the present

environment. Never be in a position for someone else can pull the rug out from under you (excessive leverage). Look at the production (cash flow) of an asset rather than the price.

14) *Shouldn't more of the economic stimulus money go to infrastructure, an investment the public can profit from for years to come?*

**CM:** Yes!

**WB:** There is usually a fair amount of waste in any big resource commitment, but can you imagine if we had thousands of earmarks attached after Pearl Harbor to the Declaration of War? Ridiculous. The level of earmarking, and the number of extraneous amendments attached to spending bills is distressing. With that said, government does need to step in when personal spending steps back.

**CM:** One no brainer for investment should be the national electricity grid.

15) *How does a strong balance sheet help, when weak companies can use cheap TARP money to finance operations?*

**WB:** It's a big disadvantage to not have access to that cheap funding. Clayton Homes has engaged in responsible lending, but financing is expensive, making the business difficult. We are trying to bring in government guaranteed entities to help with financing. But BRK as a whole is not overly dependant on its borrowing costs; it uses the \$58 billion in float from insurance to finance other subsidiaries.

**CM:** Don't forget the advantages of not being regulated.

16) *What would Ben Graham have to say about derivatives?*

**WB:** He wouldn't like them on the systematic level. Leverage is too easy, and too many counter-party risks are introduced. However, if he saw the right price, he would take advantage of them, while remaining defensive. In the 1930s we enacted many regulations to limit leverage in the form of margin requirements. Derivatives circumvent these regulations, and have allowed high leverage to sneak back into the system. We as enacted very short (T+3) settlement periods. Derivatives with long terms and settlement dates have allowed the counter-party risks to rise.

**CM:** There is a deeper problem. Derivatives dealing is inherently a dirty business. The house has an advantage, with most contracts being sold worthless. The house gets to play the same game, but sees all of the cards, and sells bad bets to clients.

17) *The restructuring of the Auto Makers required concessions of both the bond and equity holders. With the Banks, only the Equity holders were wiped out. What is the right balance?*

**WB:** There are large differences between institutions. When there is lots of equity at a firm, there is no reason to go up the structure. Most Banks were cash flow positive, and so had equity value. The Auto Makers were loosing money, with slim prospects of recovery, so the equity is worth nothing, and it has to come from the bond holders.

18) *If you were starting a small investment firm today (gives "hypothetical" details, including name, obviously his firm), how would you manage big swings in investment values in terms of balancing turnover with re-balancing?*

**WB:** It doesn't matter what the cost of an investment was, only what your valuation is today, and what the market is willing to pay you today. You don't sell because something has gone up; you sell because you believe it is overvalued.

**CM:** What he is tactfully trying to say is that you need to change your whole way of thinking.

19) *The two things you have said to look for in a business are a sustainable competitive advantage, and a simple business model. BRK is not simple, and you, Warren, are not sustainable. Would you invest in BRK?*

**WB:** I am not the advantage of BRK. The advantage is the unique structure, culture and an investor base committed to the long term. All of these things may be difficult or take a very long time for a competitor to build up.

**CM:** The advantage of the decentralized structure will continue long after...

20) *How do you advocate holding stocks forever when fundamentals changes?*

**WB:** We do sell, but when in doubt, hold. Our confidence in a business and its managers changes very slowly. I often ask CEOs what they would change if they owned the whole place. BRK businesses tend not to have a list, because they are given a free hand.

21) *Why should investors buy BRK instead of directly investing in its investments?*

**WB:** Plenty of people do invest direct, and it might be smart thing. But they can't invest with the free float that BRK has, and they can't get access to some of the deals that BRK can.

22) *I'm 11 years old. How will inflation affect my generation, how can I prepare for this, and how is BRK preparing for this?*

**WB:** We are bound to have inflation given current policies. There are a lot of incentives of politicians in all countries to inflate their currencies. The best protection against inflation is to invest in your own skills. The second best is to invest in a good business with low capital requirements.

**CM:** I agree, become a brain surgeon and buy Coca-Cola.

23) *What is your outlook on Newspapers?*

**WB:** The current environment has accentuated long standing problems with Newspapers. I would not buy Newspapers today at any price. They once were essential, but not any longer. However, as long as we do not face unending losses, we will not sell our existing Newspapers.

24) *Given how consumer spending has changed, will earnings in BRK consumer areas still be down 20% in 3 years?*

**WB:** I think housing will bottom in 2-3 years and will then start to help our housing companies. This behavior shift is significant, and will have a long term impact. Retail Commercial Real Estate will be in trouble for many years. FL Residential in trouble for long time.

25) *Possibility of a buy back?*

**WB:** My comments which were favorable to buybacks were many years ago. I think many of the recent buybacks were overpriced and detrimental to shareholders. I would consider a buyback under the right conditions. The last time I considered one was 2000.

26) *What were some of the opportunity to cost decisions in the past year?*

**WB:** When things are moving fast, decisions are harder to make, there are lots of opportunities, but their relative value changes quickly. I am always very conscious of cash levels, and having cash on hand to take advantage of opportunities. Sometimes you have to move fast. The opportunity for the Goldman Sachs investment might have only existed for a few days.

27) *GEICO has been spending \$600 million on advertising, how do you measure the return on this investment?*

**WB:** Famous saying: "We waste half of our advertising budget. We just don't know which half." [John Wanamaker?] Spending on advertising will expand, and we will spend more on advertising than competitors. If I thought we could double advertising spending tomorrow, and get anywhere near the same results, I would do it. For GEICO, we need to be firmly in people's mind when the decision to save money comes up.

28) *How would you separate good banks (Wells Fargo) from bad banks during the downfall of last year?*

**WB:** You can't. I was wrong on Irish Banks. WFC has a different model from most banks. I didn't fully understand the loan exposure of the Irish Banks, which was involved in too much new home development. WFC amortizes deposits more aggressively, leading to more conservative accounting than most banks. [WFC was up 23% the Monday after the meeting]

29) *BYD (a Chinese electronics and auto manufacturer) looks more like a speculative play than a value investment.*

**CM:** It's not a speculation, it's a damn miracle. They started with lithium batteries. Most recently they decided to get into Automobiles, with no previous experience in the area, and no partnership with foreign automakers. They now build the most popular car in China fully in house, no off the shelf parts. They have 17,000 engineers. The Chinese are very talented group of people.

30) *Forecast for the dollar?*

**WB:** There will be inflation, but the same thing will be happening around the world, even in Germany, so it is very hard to predict the fluctuation of exchange rates.

31) *Can you quantify the damage of the rating downgrade?*

**WB:** It has had very little impact on financing costs. Reminds him of something CM tells him: "You'll see it my way in the end, because you're smart and I'm right." Found the movements in BRK CDS as very interesting. Due to large options positions sold by BRK, the holders of those options were forced by their audit committees to reduce counter-party risk to BRK by buying CDS. This drove up the CDS spreads without any changes in BRK. This made holding these options even more unfavorable (you have to pay premiums, and then pay CDS insurance each year, starts to add up).

32) *When will the return on investment point be for Windfarms.*

Kind of a non-answer.

33) *The Bank of America – Merrill Lynch deal lacked disclosure. Is the safety of the banking system more important than shareholder rights?*

**WB:** December was a very fragile period for the banking system and I can understand why pressure was placed.

**CM:** After the contract had already been signed, an attempt to get out of the deal by BOA would have been weasely.

34) *What will be the net effect of new regulations on BRK companies? Which will be helped, which will be hurt?*

**CM:** There will be new rules, but it is very hard to predict the interaction of lobbying and the culture of hatred towards the financial system, and what will result.

**WB:** Washington wants to deflect the hatred towards the bankers and away from themselves. We can't predict the results, but BRK will adapt.

35) *Give BRK size, historical growth rates seem unsustainable. Do you have a forward target growth rate?*

**WB:** We won't match the past growth rates. We hope to beat the S&P by a few percent a year on average.

36) *Your current investment in China is small, what are your future plans for investment in China?*

**WB:** We don't know the future, we respond to investment opportunities. There are restrictions on some businesses, such as insurance, where BRK cannot own more than 24.9% of a company operating in China. We are very positive on China. We are less concerned about their holdings in US Treasuries. If we continue to run a deficit, and they wish to run a surplus, then China will have to hold USD assets of some kind, whether it is Treasuries or something else.

37) *You have said that management should do post mortems on acquisitions. What has been your post mortem analysis of the General RE acquisition?*

**WB:** We do believe in post mortems, but we don't think they should be made public. General RE was a big problem in 1998, but recent years of strong management have brought General RE up to par.

38) *Contracts with Employees?*

**WB:** Absent a union, we are not big believers in employee contracts. You can't contract passion, and if we are wrong on finding passionate employees and management, a contract won't save us.

**CM:** We don't want to negotiate the size of executive bathrooms.

39) *Any consideration of spin-offs or consolidations of BRK businesses?*

**WB:** No spin-offs. I have no interest in short term multiplier gains. BRK has the advantage of tax efficient capital redeployment. More subsidiaries mean more opportunities. The only sure thing in a spinoff deal is that the investment bank will make fees.

40) *The student loan business is a good one, but there appears to be more regulation coming. Is it something you are interested in?*

**WB:** Not my area of expertise.

**CM:** There has been some scandal in terms of how loans are sold, but it not an area of active interest.

41) *Were GE and Goldman Sachs attractive businesses or attractive securities? It would appear that they engage in significant earning manipulation, something you have frowned upon.*

**WB:** Everyone manipulates earnings to some degree. I feel good about the businesses, but was most interested in the securities which existed due to the unique environment, and only for a short period of time.

42) *The BRK businesses are great, but are there significant issues with the world economy which could undermine even good businesses? Is fiat currency going to break the system? Do we need a gold standard?*

**WB:** There are always problems with the world, but it's the only one we have. The system works, and there is a lot of open road left for advancement. For instance, China has picked the right policies and systems, and will continue to unleash productivity and grow.

**CM:** Solar energy has fantastic potential in the coming decades. If you have enough energy, you can solve a lot of your other problems.

43) *Swiss RE, how can you get comfortable with a lack of control?*

44) *How do you design compensation to promote investment for long term performance?*

**WB:** Each company is different, but each compensation system must include some cost of capital factor. Compensation is broken at many companies because the CEO has too much influence on his own salary. The CEO might appoint the compensation committee, and cross held board seats make corporate boards too clubby.

45) *What is the worst case scenario for the insurance businesses?*

**WB:** Nationalization.

46) *I'm a foreign investor and I'm worried about the impact of US Dollar depreciation on my BRK investment. Does BRK have any plans to diversify their operations across more currencies?*

**WB:** You can always hedge your currency exposure, not that I'm saying that's a good idea. I'm no good at predicting the future of the EUR-USD rate.

**CM:** You did OK last year.

**WB:** Well, we did make a couple billion! We'll continue to look for opportunities abroad, but we do not have an active global diversification plan.

47) *What is your attitude towards layoffs at BRK companies?*

**WB:** Business conditions change, in both temporary and permanent ways, and layoffs are sometimes necessary. There is no joy in it, but it must be done. In most cases, we probably wait too long. Some business can operate at fractional capacity, but others don't lend themselves to that.

48) *What can shareholders do to fix executive compensation?*

**WB:** There was a huge impact and anger associated with AIG that could spill over into other companies. All we really need is for the 6 largest investment managers to speak out about compensation levels at certain companies. They wouldn't need to do it often for most companies to reform their practices.

49) *When looking for new managers, describe an interview?*

**WB:** We aren't looking to find out if a manager is good during an interview. We hire managers that have proven themselves by running successful companies. Our only concern during this process is if they will stay.

50) *You wrote last Fall about buying US Equities. Are you still buying, and how would you rate today's opportunities?*

**WB:** Today's opportunities are great, but are not as good as the 70's. Of course, interest rates were different, so it is a difficult comparison. I can't predict movements in the next 6, 12 or even 24 months, but I believe that 10 years from this will prove to be a fantastic buying opportunity.

**CM** agrees.

51) *You have said to beware of capital intensive businesses. How do you reconcile this with investment in utilities?*

**WB:** The returns from utilities are sufficiently steady, and ensured by legislation that we are more comfortable with the higher capital requirements.

52) *How can we improve the economy?*

**WB:** Well, I spoke earlier about creation of households being the key to housing recovery, so...

**Questioner** (a nephew of Warren's?): "Well in that case", proposes to his girlfriend.