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1994

18. "Two yardsticks" for judging management

AUDIENCE MEMBER: Secondly, you talk about good management with corporations and that you try and buy companies with good management. I feel that I have about as much chance of meeting good managers, other than yourself, as I do bringing Richard Nixon back to life. How do I, as an average investor, find out what good management is?

WARREN BUFFETT: Well, **I think you judge management by two yardsticks. One is how well they run the business and I think you can learn a lot about that by reading about both what they've accomplished and what their competitors have accomplished, and seeing how they have allocated capital over time. You have to have some understanding of the hand they were dealt when they themselves got a chance to play the hand**.

But, if you understand something about the business they're in — and you can't understand it in every business, but you can find industries or companies where you can understand it — **then you simply want to look at how well they have been doing in playing the hand, essentially, that's been dealt with them. And then the second thing you want to figure out is how well that they treat their owners.** And I think you can get a handle on that, oftentimes. A lot of times you can't. I mean it — they're many companies that obviously fall in — somewhere — in that 20th to 80th percentile and it's a little hard to pick out where they do fall.

But, I think you can usually figure out — I mean, it's not hard to figure out that, say, Bill Gates, or Tom Murphy, or Don Keough, or people like that, are really outstanding managers. And it's not hard to figure out who they're working for. And I can give you some cases on the other end of the spectrum, too. **It's interesting how often the ones that, in my view, are the poor managers also turn out to be the ones that really don't think that much about the shareholders, too. The two often go hand in hand. But, I think reading of reports — reading of competitors' reports — I think you'll get a fix on that in some cases.** You don't have to — you know, you don't have to make a hundred correct judgments in this business or 50 correct judgments. You only have to make a few. And that's all we try to do.

And, generally speaking, the conclusions I've come to about managers have really come about the same way you can make yours. I mean they come about by reading reports rather than any intimate personal knowledge or — and knowing them personally at all. So it — you know, read the proxy statements, see what they think of — see how they treat themselves versus how they treat the shareholders, look at what they have accomplished, considering what the hand was that they were dealt when they took over compared to what is going on in the industry.

And I think you can figure it out sometimes. You don't have to figure out very often.

- Some businesses are a lot easier to understand than others. And Charlie and I don't like difficult problems. All kinds of things just intrinsically create problems. And some people think that if you jump over a seven-foot bar that the ribbon they pin on you is going to be worth more money than if you step over a one-foot bar. And it just isn't true in the investment world, at all. **The big thing to do is avoid being wrong.**
- And, you know, **I've said in investing, in the past, that there's more than one way to get to heaven. And there isn't a true religion in this, but there's some very useful religions.**

Ignoring Macro

If we're right about a business, if we think a business is attractive, it would be very foolish for us to not take action on that because we thought something about what the market was going to do, or anything of that sort. Because we just don't know. And to give up something that you do know and that is profitable for something that you don't know and won't know because of that, it just doesn't make any sense to us, and it doesn't really make any difference to us. I mean, I bought my first stock in, probably, April of 1942 when I was 11. And since then, I mean, actually World War II didn't look so good at that time. I mean, the prospects, they really didn't. I mean, you know, we were not doing well in the Pacific. I'm not sure I calculated that into my purchase of my three shares.

We buy businesses. We buy pieces of businesses: stocks. And we're going to be much better off if we can buy those things at an attractive price than if we can't. So we don't have any fear at all. I mean, what we fear is an irrational bull market that's sustained for some long period of time.

CHARLIE MUNGER: No. **I think the — if you're agnostic about those macro factors and therefore devote all your time to thinking about the individual businesses and the individual opportunities, it's just, it's a way more efficient way to behave, at least with our particular talents and lacks thereof.**

WARREN BUFFETT: **If you're right about the businesses, you'll end up doing fine.** We don't know, and we don't think about when something will happen. **We think about what will happen. It's fairly, it's not so difficult to figure out what will happen. It's impossible, in our view, to figure out when it will happen. So we focus on what will happen.** This company in 1890 or thereabouts, the whole company sold for $2,000. It's got a market value now of about 50-odd-billion, you know?

Somebody could've said to the fellow who was buying this in 1890, you know, "You're going to have a couple of great World Wars, and you know, you'll have the panic of 1907, all these things will happen. And wouldn't it be a better idea to wait?" (Laughter) We can't afford that mistake, basically. Yeah.

48. We'd rather buy an entire company, but stocks offer more bargains

WARREN BUFFETT: Well, I would answer that no. We do not — we very seldom find something to buy on a negotiated basis for an entire business. We have certain size requirements. A big limiting factor is it has to be something we can understand. I mean, that eliminates 95 percent of the businesses. And we don't pay any attention to them, but we get lots of proposals for things that just are totally outside the boundaries of what we've already said we're interested in. We prefer to buy entire businesses, or 80 percent or greater interest in businesses, partly for the tax reasons you mentioned, and frankly, we like it better. We just, it's the kind of business we would like to build if we had our absolute druthers on it.

Counter to that is we can usually get more for our money in wonderful businesses, in terms of buying little pieces of them in the market, because the market is far more inefficient in pricing businesses than is the negotiated market. **You're not going to buy any bargains, and I mean, you shouldn't even approach the idea of buying a bargain in a negotiated purchase. You want to buy it from people who are going to run it for you. You want to buy it from people who are intelligent enough to price their business properly, and they are. I mean, that's the way things are.**

The market does not do that. The market — in the stock market, you get a chance to buy businesses at foolish prices, and that is why we end up with a lot of money in marketable securities. If we absolutely had our choice, we would own a group of — we would own three times the number of businesses we own outright. We're unlikely to get that opportunity over time, but periodically we'll get the chance to find something that fits our test.

And in between we will, when the market offers us the right prices, we will buy more, either businesses we already own pieces of, or we'll buy one or two new ones. Something's usually going on. There are tax advantages to owning all of them, but that's more than offset by the fact that you'll never get a chance to buy the whole Coca-Cola Company or the whole Gillette company. I mean, businesses like that, sensational businesses, are just not available. Sometimes you get a chance to make a sensible purchase in the market of such businesses.

CHARLIE MUNGER: Well, I think that's exactly right. And if you stop to think about it, if a hundred percent of a business is for sale, you've got — the average corporate buyer is being run by people who have the mindset of people buying with somebody else's money. And we have the mindset of people buying with our own money.

And there's also a class of buyers for a hundred percent of businesses who are basically able and assured financial promoters. I'm talking about the leveraged buyout funds and so on. And those people tend to have the upside, but not the downside, in the private arrangements they've made with their investors. And naturally, they tend to be somewhat optimistic. And so we have formidable competition when we try and buy a hundred percent of businesses.

WARREN BUFFETT: Most managers are better off, in terms of their personal equation, if they're running something larger. And they're also better off if they're running something larger and more profitable. But the first condition alone will usually leave them better off. We're only better off if we're running something that's more profitable. We also like it if it's larger, too. But our equation, actually, our personal equation is actually different than a great many managers in that respect. Even if that didn't operate, I think most managers psychically would enjoy running something larger. And if you can pay for it with other people's money, I mean, that gets pretty attractive.

You know, how much would — and let's just say you're a baseball fan — well, how much would you pay to own whatever your hometown, the Yankees? You might pay more if you were writing a check on someone else's bank account than if you were writing it on your own. It's been known to happen. (Laughter) And in corporate America, animal spirits are there. And those are our competitors on buying entire businesses. In terms of buying securities, most managers don't even think about it. **It's very interesting to me, because they'll say that — they'll have somebody else manage their money in terms of portfolio securities. Well, all that is is a portfolio of businesses. And I'll say, "Well, why don't you pick out your own portfolio?" And they'll say, "That's much too difficult."**

And then some guy will come along with some business that they never heard of a week before and give them some figures and a few projections, and the guy thinks he knows enough to buy that business. It's very puzzling to me sometimes.

53. Don't need interest rate outlook to value companies

WARREN BUFFETT: **Well, the value of every business, the value of a farm, the value of an apartment house, the value of any economic asset, is 100 percent sensitive to interest rates**, because all you are doing in investing is transferring some money to somebody now in exchange for what you expect the stream of money to be, to come in, over a period of time. And the higher interest rates are, the less that present value is going to be. So every business, by its nature, whether it's Coca-Cola or Gillette or Wells Fargo, is in its intrinsic valuation, is a hundred percent sensitive to interest rates.

Now, the question as to whether a Wells Fargo or a Freddie Mac or whatever it may be, whether their business gets better or worse internally, as opposed to the valuation process, because of higher interest rates, that is not easy to figure. I mean, GEICO, if they write their insurance business at the same underwriting ratio — in other words they have the same loss and expense experience relative to premiums — they benefit by higher interest rates, obviously, over time, because they're a float business, and the float is worth more to them.

Now, externally, getting back to the valuation part, the present value of those earnings also becomes less then. But the present value of Coke's earnings becomes less in a higher interest rate environment. Wells Fargo, it's — whether they earn more or less money under any given interest rate scenario is hard to figure. There may be one short-term effect and there may be another longterm effect. So I do not have to have a view on interest rates — and I don't have a view on interest rates — to make a decision as to an insurance business, or a mortgage guarantor business, or a banking business, or something of the sort, relative to making a judgment about Coke or Gillette.

8. Unlikely to write put options on Coca-Cola again

Last year you were using Coca-Cola puts as a way to increase income, and conversely, if they were exercised, as a way of increasing your position. Do you still use puts in this type on investments you wish to add to?

WARREN BUFFETT: — five million shares, as I remember, of Coke sometime in the early fall or thereby — I don't remember exactly — last year. And the puts, I think the premium was around 7 1/2 million dollars, and they were priced around 35. We have not done that very often, and we're unlikely to do very much of it. For one thing, there are position limits on puts, which don't apply to us, but they apply to the brokers for which we do them. And those position limits were not clear before that. But we could probably write puts on that same amount by doing it through a bunch of different brokers. It's not something we're really very likely to do. I was happy to do it, and in that particular case, we made 7 1/2 million dollars.

But we're better off, probably — if we like something well enough to write a put on it, we're probably better off buying the security itself, and particularly since we can't do it in the kind of quantities that really would make it meaningful to Berkshire. There are securities I would not mind writing puts for 10 million shares or something, but I — that probably — it's probably allowable for us to do it. It's not allowed — we'd probably have to do it through multiple brokers to get the job done.

12. We don't like to "give you our answers" on Coca-Cola

WARREN BUFFETT: You really have to come to your own conclusion. Coca-Cola Company writes — their annual reports are extremely good. I mean, they're very informative. You know, you — **My guess is that, at least, if you read a few of the reports, you'd absolutely know as much about the Coca-Cola Company as I would. But in the end, you have to make your own decisions about growth potential, profitability potential, and all that. But the one thing I can assure you is that, probably, if you spend a relatively small amount of time on it, the facts that you will have available to you for making a decision on that question will be just as good, essentially, as the facts you'd get if you'd worked at the Coca-Cola Company for 20 years, or if you were a food and beverage analyst in Wall Street or anything of the sort.**

That's the kind of businesses we like to look at, are things that we think we can understand that way. And they're also businesses that, usually, I think you could understand that way.

Valuation

WARREN BUFFETT: It — assuming we get enough for our money when we do it. So, it — we are not looking — we are looking at projecting numbers out, as to what kind of cash we think we'll get back over time. But you know, would you rather have a savings — if you're going to put a million dollars in a savings account, would you rather have something that paid you 10 percent a year and never changed, or would you rather have something that paid you 2 percent a year and increased at 10 percent a year? Well, you can work out the math to answer those questions.

But you can certainly have a situation where there's absolutely no growth in the business, and it's a much better investment than some company that's going to grow at very substantial rates, particularly if they're going to need capital in order to grow. **There's a huge difference in the business that grows and requires a lot of capital to do so, and the business that grows, and doesn't require capital. And I would say that, generally, financial analysts do not give adequate weight to the difference in those. In fact, it's amazing how little attention is paid to that. Believe me, if you're investing, you should pay a lot of attention to it.**

1995

My question is, can someone apply your investment principle, business philosophy, and your discipline in life to build a portfolio of, say, five or six high-technology company? Let's call it Berkshire Hathaway Technology Fund? (Laughter)

WARREN BUFFETT: We try not to get into things we — that we don't understand. And if we're going to lose your money, we want to be able to come before you, you know, next year and tell you we lost your money because we thought this and it turned out to be that. **We don't want to say, you know, somebody wrote us a report saying if, you know, "This is what's going to happen," in some field that we don't understand and that, therefore, we lost your money by following someone else's advice. So, we won't do it ourselves.** At — I think that the principles — **I think Ben Graham's principles — are perfectly valid when applied to high-tech companies. It's that we don't know how to do it, but that doesn't mean somebody else doesn't know how to do it.**

My guess is that if Bill Gates were thinking about some company in an arena that he understood and that I didn't understand, he would apply much the same way of thinking about the investment decision that I would. He would just understand the business. I might think I understand Coca-Cola or Gillette. And he may have a — he may have the ability to understand a lot of other businesses that seems as clear to him as Coke or Gillette would seem to me. I think once he identified those, he would apply pretty much the same yardsticks in deciding how to act.

I think he would act — I think he would have a margin of safety principle that might be a little different because there's essentially more risk in a high-tech company. But he would still have the margin of safety principle on a — sort of adjusted for the mathematical risk of loss in his mind. He would have — he would look at it as a business, not as a stock. You know, he would not buy it on borrowed money. I mean, it — a bunch of principles would be carried through. But our circle of things we understand is really unlikely to enlarge, maybe a tiny bit here or there. But if the capital doesn't get too large, the circle's OK. And — but we will not —if we have trouble finding things within our circle, we will not enlarge the circle. You know, we'll wait. That's our approach.

- And, you know, that's one of the things I liked about Graham's book. I mean, you know, he wrote — everything he wrote sort of made sense. He didn't sort of get into all the frills and try and make it more complicated than it really, truly is.

23. Big assets make float more flexible

I was reading through your annual report. And to me, an eye-popping number in there was the amount of float in 1994, at a cost of less than zero — I think it was $3 billion. **And I was wondering if there are any restrictions on your investment of that money, or can that go into your marketable equity securities?**

WARREN BUFFETT: The question relates to — we have that long table we put in — we introduced about four years ago or so in the annual report, that shows the amount of float and the cost of float. And that's a very important table. It — in terms of our operating businesses, that's probably the most important piece of information in the report. And that float is, as you noted, well over $3 billion now — last year, because of various favorable factors, including the fact that our super-cat business was favorable, but also, because our other insurance businesses did very well — amazingly well.

The cost of that float, which is money that we're holding that eventually — does not belong to us, but will go to somebody else. The cost of that float was less than zero, and that is a very valuable asset. And the question is, how much flexibility we have in investing that, which I think was the core of your question.

The answer is we have a lot of flexibility. We are not disadvantaged by that money being in float, as opposed to equity, really, in any significant way. Now, if we had a very limited amount of equity and a very large amount of float, we would impose a lot of restrictions on ourselves as to how we would do it, because we would want to be very sure that we were in a position to distribute that float, in effect, to policyholders, or claimants, or whatever it may be at the time that was appropriate. **But we have so much net worth that, in effect, that float is just about as useful to us as equity money.** And that means quite useful. It's a big asset of Berkshire's.

Moat

WARREN BUFFETT: Yeah, to some extent, **Charlie and I try and distinguish between businesses where you have to have been smart once and businesses where you have to stay smart. And, I mean, retailing is a good case of a business where you have to stay smart.** But you can — you are under attack all of the time. People are in your store. If you're doing something successful, they're in your store the next day trying to figure out what it is about your success that they can transplant and maybe add a little something on in their own situation. So, you cannot coast in retailing.

There are other businesses where you only have to be smart once, at least for a very long time. There was once a southern publisher who was doing very well with his newspaper. And someone asked him the secret of his success. And he said monopoly and nepotism. (Laughter) And I mean, he wasn't so dumb. I mean, he didn't have any illusions about himself. **And if you had a big network of television affiliates station 30 years ago, there's still a major difference between good management and bad management. I mean, a major difference. But you could be a terrible manager and make a fortune, basically. Because the one decision to own the network TV affiliate overcame almost any deficiency that existed from that point forward.**

And that would not be true if you were the first one to come up with some concept in retailing or something of the sort. I mean, you would have to be out there defending it every day. Ideally, you know, is you want terrific management at a terrific business. And that's what we look for. But as we pointed out in the past, if you have to choose between the two, get a terrific business.

Ben Graham

The — I still prefer the — I think the second edition is cheaper to buy than the first edition, by some margin. And I think it's basically the same book. So, I — that's the one I would recommend. I — it isn't because of differences on value and growth. **I just think that the reasoning is better and more consistent throughout the second edition, which is really the last one that Ben was the hundred percent — along with Dave Dodd helping him in various ways — was responsible for writing.**

So, I think that the book has gotten away, to quite an extent, from both Graham's thinking and from his way of expressing himself. So I really — but I have no quarrel with anybody that wants to read later editions at all. I do think, probably, the second edition, if you're a real student of security analysis and you read and understand that, you'll — you should do all right.

31. Focus on Graham's three principles

AUDIENCE MEMBER: John Rankin (PH), Fort Collins, Colorado. Thanks for having us. In the book, "Warren Buffett Way," the author describes the capital growth model that you've used to evaluate intrinsic value in common stock purchases. My question is, do you also still use the formula Ben Graham described in "The Intelligent Investor," that uses evaluating anticipated growth, but also book value? It seems to me that fair value is always a bit higher when using Mr. Graham's formula than the stream of cash discounted back to present value that is in "Warren Buffett Way" and also that you've alluded to in annual reports.

WARREN BUFFETT: Yeah, we've tried to put in the annual report pretty much how we approach securities. And book value is not a consideration — virtually, not a consideration at all. And the best businesses, by definition, are going to be businesses that earn very high returns on capital employed over time. So, by nature, if we want to own good businesses, we're going to own things that have relatively little capital employed compared to our purchase price.

That would not have been Ben Graham's approach. But Ben Graham was — Ben was not working with very large sums of money. And he would not have argued with this approach, he just would've said his was easier. And it is easier, perhaps, when you're working with small amounts of money.

My friend Walter Schloss has hewed much more toward the kind of securities that Ben would've selected. But he's worked with smaller amounts of money. He has an absolutely sensational record. And it's not surprising to me at all. I mean, when Walter left Graham- Newman, I would've expected him to do well.

But I don't look at the primary message, from our standpoint, of Graham, really, as being in that — in anything to do with formulas. In other words, there's three important aspects to it. You know, one is your attitude toward the stock market. That's covered in chapter eight of "The Intelligent Investor." I mean, if you've got that attitude toward the market, you start ahead of 99 percent of all people who are operating in the market. So, you have an enormous advantage.

Second principle is the margin of safety, which again, gives you an enormous edge, and actually has applicability far beyond just the investment world. And then the third is just looking at stocks as businesses, which gives you an entirely different view than most people that are in the market. And with those three sort of philosophical benchmarks, the exact — the evaluation technique you use is not really that important. Because you're not going to go way off the track, whether you use Walter's approach — Walter Schloss's — or mine, or whatever. Phil Carret has a slightly different approach. But it's got those three cornerstones to it, I will guarantee. And believe me, he's done very well.

9. Comparing investing styles of Ben Graham and Phil Fisher

AUDIENCE MEMBER: Yes, Neil McMahon (PH), New York City, also a Sequoia shareholder. Ben Graham investing encouraged turnover. Looking at Berkshire's holdings, concentration and long-term, are you still a 15 percent Phil Fisher and 85 percent Graham?

WARREN BUFFETT: I don't know what the percentage would be. I'm a hundred percent Ben Graham in those three points I mentioned earlier, and those really count. I am very — I was very influenced by Phil Fisher when I first read his two books, back around 1960 or thereabouts. And I think that they're terrific books, and I think Phil is a terrific guy. So, I think I probably gave that percentage to — I think I first used it in Forbes one time when Jim Michaels wrote me. And I think I, you know, it was one of those things. I just named a number.

But I think I'd rather think of myself as being a sort of a hundred percent Ben Graham and a hundred percent Phil Fisher in the points where they don't — and they really don't — contradict each other. It's just that they had a vastly different emphasis. Ben would not have disagreed with the proposition that if you can find a business with a high rate of return on capital that can keep using more capital on that — that that's the best business in the world. And of course, he made most of his money out of GEICO, which was precisely that sort of business.

So, he recognized it, it's just that he felt that the other system of buying things that were statistically very cheap, and buying a large number of them, was an easier policy to apply, and one that was a little more teachable. He would've felt that Phil Fisher's approach was less teachable than his, but his had a more limited value because it was not workable with really large sums of money.

At Graham-Newman Corp — Graham-Newman Corp was a closed-end fund — oh, it was technically an open-end fund, but it had $6 million of net worth. And Newman and Graham, the partnership that was affiliated with it, had 6 million. So, you had a total pool of 12 million. Well, you could go around buying little machine tool companies — stocks in machine tool companies, whatever it might be, all statistically cheap. And that was a very good group operation. **And he had — you have — if you own a lousy business, you have to sell it at some point. I mean, if you**

own a group of lousy businesses, you better hope some of them get taken over or something happens. You need turnover. If you own a wonderful business, you know, you don't want turnover, basically.

CHARLIE MUNGER: **What was interesting to me about the Phil Fisher businesses is that a very great many of them didn't last as wonderful businesses.** One of his businesses was Title Insurance and Trust Company, which dominated the state of California. It had the biggest title plant, which was maintained by hand, and it had great fiscal solvency, and integrity, and so forth. It just dominated a lucrative field. And along came the computer, and now you could create, for a few million dollars, a title plant and keep it up without an army of clerks.

And pretty soon, we had 20 different title companies, and they would go to great, big customers like big lenders and big real estate brokers, and pay them outlandish commissions by the standards of yore, and bid away huge blocks of business. And in due course, in the State of California, the aggregate earnings of all the title insurance companies combined went below zero — starting with a virtual monopoly.

WARREN BUFFETT: From what looked like a monopoly.

CHARLIE MUNGER: **So, very few companies are so safe that you can just look ahead 20 years. And technology is sometimes your friend and it's sometimes your bitter enemy.** If Title Insurance and Trust Company had been smart, they would've looked on that computer, which they saw as a cost reducer, as one of the worst curses that ever came to man.

WARREN BUFFETT: **You can — it probably takes more business experience and insights, to some degree, to apply Phil Fisher's approach than it does Graham's approach. If you — The only problem is, you may be shut out of doing anything for a long time with Ben's approach, and you may have a lot of difficulty in doing it with big money.** But if you strictly applied, for example, his working capital test to securities, you know, it will work. It just may not work on a very big scale, and there may be periods when you're not doing much.

Ben really was more of a teacher than a — I mean, he had no urge to make a lot of money. It did not interest him. So he was — he really wanted something that he thought was teachable as a cornerstone of his philosophy and approach. And he felt you could read his books sitting out here in Omaha and apply — buying things that were statistically cheap, and you didn't have to have any special insights about business or consumer behavior, or anything of the sort. And I don't think there's any question about that being true, but I also don't think you can manage lots of money in accord with it.

Accounting

Obviously, if some prepaid expense, deferred asset accounts start building up suspiciously high, and inventories look out of line, you know, with sales and, particularly, the trend of them and all that, you want to look twice at companies like that. Life insurance, you know, frequently, you know, we see weak accounting in. You can — when you don't have a product where revenues and expenses are being matched up on something close to cash in the short-term, you have the opportunity for people playing games with numbers.

And some people have learned how to do that very well, and they've sometimes created longlasting stock manipulation or promotion schemes that have enriched themselves, or they've enriched the managers or the creators of it, at the expense of the public, over time. If you ever get suspicious about accounting, just go onto the next company.

31. Secret to avoiding lawsuits: "You can't make a good deal with a bad person"

WARREN BUFFETT: Yeah. It was — you know, there — you cannot protect yourself against lawsuits, and there are certainly a lot of frivolous ones we've — like I say, we have — it's not been a drain on our time or money — but particularly time — to date. **And I think one thing you'd have to do is, if you ran into anything of that sort, you**

would not pay and you would make life as — try to make life comparably difficult for the other party as they made it for you. But that has not been our experience so far.

WARREN BUFFETT: You can't — yeah, **we basically have the attitude that you can't make a good deal with a bad person.** And you can — that means we just forget about it. We just forget about it. We can do fine over time, dealing with people that we like, and admire, and trust. So we have never — and a lot of people do get the idea, because the bad actor will tend to try and tantalize you in one way or another, and —you won't win. It just pays to avoid them.

35. "Advanced math is of no use" in investing

AUDIENCE MEMBER: — it's hard to continue to grow at the rate you've grown in the past because the company has gotten so big. And I'm wondering if you could elaborate a little bit on that. And my second question, which is totally unrelated, but I've also read where you're very good with numbers, with working things in your head. And I'm totally a rookie when it comes to economics and accounting and things like that, but I'm very good with numbers and keeping things in my head. And I'm wondering if there's some way a mathematician who knows very little about the business world, what I could read or what I could do to learn how better to invest and how you did that.

WARREN BUFFETT: Well, going to the first question, when you say it's going to be hard — it's going to be impossible. I mean, now that's the answer. We cannot compound money at 23 percent from a $12 billion base. We don't know how to do that, and it would be a mistake for anybody to think that we could come close to that. We still — we think we can do OK with money, but we did not start with a $12 billion base. And we've never seen anybody in the world compound numbers like that, at that rate. So, we'll forget it — that part of it, but there are intelligent things we can be doing. The second part of the question, **I don't think any great amount of mathematical aptitude is — not aptitude, but mathematical knowledge is a — advanced math is of no use in the investment process.**

And understanding a mathematical relationship, sort of an ability to quantify — a numeracy, as they call it, I think that's generally helpful in investments because something that tells you when things make sense or don't make sense, or sort of how an item in one area relates to something someplace else.

But that doesn't really require any great mathematical ability. It really requires sort of a mathematical awareness and a numeracy. And I think it is a help to be able to see that. I mean, **I think Charlie and I probably, when we read about one business, we're always thinking of it against a screen of dozens of businesses — it's just sort of automatic, and — But that's just like a scout in baseball thinking about one baseball player against an alternative. I mean, you only have a given number on the squad and thinking, you know, "One guy may be a little faster, one guy can hit a little better," all of that sort of thing. And it's always in your mind, you are prioritizing and selecting in some manner.**

My own feeling about the best way to apply that is just to read everything in sight. You know, I mean, if you're reading a few hundred annual reports a year and you've read Graham, and Fisher, and a few things, you'll soon see whether it kind of falls into place or not.

CHARLIE MUNGER: Yeah. **I think the set of numbers — the one set of numbers in America that are the best quick guide to measuring one business against another are the Value Line numbers.**

WARREN BUFFETT: I'd agree with that.

CHARLIE MUNGER: **That stuff on the log scale paper going back 15 years, that is the best oneshot description of a lot of big businesses that exists in America.** I can't imagine anybody being in the investment business involving common stocks without that thing on the shelf.

WARREN BUFFETT: **And, if you sort of have in your head how all of that looks in different industries and different businesses, then you've got a backdrop against which to measure. I mean, if you'd never watched a baseball game**

and never seen a statistic on it, you wouldn't know whether a .300 hitter was a good hitter or not. You have to have some kind of a mosaic there that you're thinking is implanted against, in effect. And the Value Line figures, you know, they cycle it every 13 weeks. And if you ripple through that, you'll have a pretty good idea of what's happened over time in American business.

CHARLIE MUNGER: By the way, I pay no attention to their timeliness ratings, or stock ratings.

WARREN BUFFETT: No, none of that means anything. It's too bad they have to put that there, but that —it's the statistical material, not the —

CHARLIE MUNGER: I would like to have that material going all the way back. They cut it off about, what, 15 years back?

WARREN BUFFETT: Yeah, we — Charlie and I — maybe even, I do it more — we tend to go back. I mean, if I'm buying Coca-Cola, I'll probably go back and read the Fortune articles from the 1930s on it or something. **I like a lot of historical background on things, just to, sort of, get it in my head as to how the business has evolved over time, and what's been permanent and what hasn't been permanent, and all of that. I probably do that more for fun than for actually decision making. But I think it is — I think if you think about if — we're trying to buy businesses we want to own forever, you know, and if you're thinking that way you might as well see what it's been like to own them forever, and look back a ways.**

36. Management made the difference for Wells Fargo

AUDIENCE MEMBER: I'm Stewart Horejsi from Salina, Kansas. When you first bought part of Wells Fargo a few years back, I looked at it and I couldn't tell it was any better than any of the other banks. I think, now, anybody that would look at it can tell it's better than almost any bank. Now you've bought PNC Bank, and again, I can't see how it's distinguished from any of the other banks. (Laughter) What did you see in PNC Bank that made you select it over all the other banks that were available?

WARREN BUFFETT: (Laughs) Well, we're not going to give any stock advice on that. So, I think that going back to Wells, it was very clear that, if you — I knew something about Carl Reichardt, and to a lesser extent at that time, Paul Hazen, from having met them and also from having read a lot of things they said. So, they were different — they were certainly different than the typical banker. And then the question was, is how much did that difference make, in terms of how they would run the place? And they ran into some very heavy seas, subsequently. And I think, probably, the difference — I probably think those human differences that were perceived earlier are what enabled them to come through as well as they did. But that's about all I can say on banks.

CHARLIE MUNGER: You know, you might add to that slightly, because that Wells Fargo thing is a very interesting example. They had a huge concentration of real estate lending, a field in which people took the biggest — It was the biggest collapse in 40 or 50 years in that field, so that if they had been destined to suffer the same sort of average loss per real estate loan that an ordinary bank would've suffered, the place would've been broke. So, we were basically betting that their real estate lending was way better than average. And indeed, it was. And they also handled it on the way down, way better than average. So, you can argue that everybody else was looking at this horrible concentration of real estate loans and this sea of troubles in the real estate field, and in bankers to the real estate field. And they just assumed that Wells Fargo was going to go broke.

And we figured, no, that since their loans were way higher quality, and their loan collection methods were way higher quality than others, that it would be all right. And so, it worked out.

WARREN BUFFETT: Yeah, we couldn't have told that — if we hadn't gone a little further, though, than just looking at numbers, we would not have been able to make that decision.

39. Expect big changes in banking over next 20 years

AUDIENCE MEMBER: The second question pertained to the permanence and durability of the banking franchise. And whether alternative delivery channels over the next few years may erode the durability of that, including the Microsoft/Intuit merger.

WARREN BUFFETT: Well, that's a good question. You're certainly seeing the value of bank branches diminish significantly. It used to be a point of enormous pride with managements, in how many branches they had. And it was, you know, often political influence and everything else was called into obtaining branch permits. The world will change in banking, probably in some very major ways, over a 20 or 30-year period. Exactly what players will benefit and which ones will be hurt, you know, is a very tough question.

But I would expect — I would not — I don't think I'd expect really significant change in banking over the next five years, but I'd certainly expect it over the next 20 years. And there are a lot of people that have their eye on that market, including Microsoft, as you mention. It may be to their advantage to hook up with the present players. I mean, I know it's certainly something that gets explored. But they may figure out a way to go around the present players, too. And that's one investment consideration.

43. Coca-Cola as "measuring stock" to evaluate alternatives

WARREN BUFFETT: Yeah, we did. We bought more last year, and it's not a bad measuring stick against buying other things. But there's — I would not rule out Berkshire buying more. I don't have any plans to do it right now, but I wouldn't rule that out at all because it's — if I'm going to look at another business I will say, you know, "Why would I rather have this than more Coca-Cola?"

CHARLIE MUNGER: **Well, there he is saying something that is very useful to practically any investor, when he said, "Use this as a measuring stick," in terms of buying other things. For an ordinary individual the best thing you have easily available is your measuring stick. If it isn't — if the new thing isn't better than what you already know is available, it hasn't met your threshold, then that screens out, you know, 99 percent of what you see, and it's an enormous thought conserver. And it is not taught in the business schools, by and large.**

WARREN BUFFETT: No, and that's why we think it's slightly nuts when big institutions decide, because everybody else is doing it, to put 4 percent of their money in international equities or 3 percent in emerging growth countries — some damn thing like that. I mean, the only reason to put the money in there is if they've measured against what they're already doing.

And if they measure it against what they're already doing and they think it's a screamingly good idea to leave 97 percent in the other place and put 3 percent in, you know, I mean, it just doesn't make any sense whatsoever.

47. Focus on future, not current, earnings

AUDIENCE MEMBER: I've got another question about valuation — more specifically, the relation of P/Es to interest rates. I understand that you don't want to lay down a rigid formula for valuation, but I also know that you don't want people to think that a multiple of 20 times earnings is cheap, or a multiple of five times earnings is expensive. So, Benjamin Graham, he devised a central value theory that valued the average stock at an earnings yield that's about a third above bond yields.

In other words, that would work out to maybe 11 times earnings, currently. And I know that you've compared the average business to a 13 percent bond that's worth roughly book at 13 percent interest rates, and worth perhaps roughly twice book at 6 percent interest rates. So, given current interest rates of 7 to 8 percent, as they are now, that would tend to imply that stocks are worth perhaps 12 to 13 times earnings. And yet, the acquisitions that I've seen in the private market have gone out at more like 17 to 20 times earnings. And I'd like to know, what do you think is the rough range of multiples that make sense?

WARREN BUFFETT: Yeah. Well, it isn't a multiple of today's earnings that is primarily determinate of things. We bought our Coca-Cola, for example, in 1988 and '89, on this stock, at a price of $11 a share. Which — as low as 9, as high as 13, but it averaged about $11. And it'll earn, we'll say, most estimates are between 230 and 240 this year. So, that's under five times this year's earnings, but it was a pretty good size multiple back when we bought it. It's the future that counts. It's like what I wrote there, what Wayne Gretzky says, to go where the puck is going to be, not where it is.

So, the current multiple interacts with the reinvestment of capital and the rate at which that capital's invested, to determine the attractiveness of something now. And we are affected in that valuation process to a considerable degree by interest rates, but not by whether they're 7.3, or 7.0, or 7.5. But I mean, we'll be thinking much differently if they're — long-term rates are 11 percent or 5 percent. And — but we don't have any magic multiples in mind. We're thinking — we want to be in the business that 10 years from now is earning a whole lot more money than it is now, and that we will still feel good about the prospects of the business at that time. That's the kind of business we're trying to buy all of, and that's the kind of business that we try and buy part of. And then sometimes we buy others, too. (Laughs)

CHARLIE MUNGER: We don't do any of that rigid formulaic stuff.

WARREN BUFFETT: There's a general framework, that you can call a formula, in our mind. **But we also don't kid ourselves that we know so much about the specifics that we would actually make a calculation, in terms of the equation. When we bought Coke in '88 and '89 we had this idea about what we thought the business would do over time, but we never reduced it to making a calculation. Maybe we should, but I mean, it just — we don't think there's that kind of precision to it. We think it's the right way to think in a general way. And we think, if you try to — if you think that you can do it to pinpoint it, you're kidding yourself**. And therefore, we think that when we make a decision, there ought to be such a margin of safety that it ought to be so attractive that you don't have to carry it out to three decimal places.

1996

P&C and Banking

The insurance business provides us with float. And float is money that we hold that doesn't belong to us. It's like a bank having deposits. A bank has deposits. The money doesn't belong to it. But it holds the money. Now, when a bank holds deposits, on everything except demand deposits, there's an explicit cost, an interest rate attached to it. And, then, there are the costs of running the system and gathering the money which is — also must be attributed both to demand and time deposit. **So there's a cost to getting what they would call deposits and we could call float.**

In the insurance business, a similar phenomenon takes place in that policy holders give us their money at the start of the policy period. And therefore, we get the money paid in advance for the product. And secondly, it takes time to settle losses, particularly in the liability area. If you bang up a fender on your car, you — it's going to get settled very quickly, so there's — but if there's a complicated injury or something, it may take some years to settle. And during that period, we hold the money.

So, we have, in effect, something that is tantamount to the deposits of a bank. But whereas the deposits of a bank, it's quite easy to calculate the approximate cost, in the case of the float that the insurance company has, you don't really know what the cost of that float is until all your policies and losses — policies have expired and your losses have all been settled. Well, that's forever, in some cases. So, you're only making an estimate, as you go along, of what that float is costing.

39. Discount rate for estimating intrinsic value

In determining a company's intrinsic value, you seem to write or indicate that you project out a company's owner earnings for a number of years, and then discount that back by prevailing rates. **My question is, how much of a premium, if any, to prevailing risk-free rates do you demand when you discount back the owner earnings of a company? Or stated differently, for example, today, with loan rates at about 7 percent, if you did the same exercise with Coca-Cola, at what rate of interest would you discount back their owner earnings?**

WARREN BUFFETT: Yeah. **We get asked that question a lot. And we've answered it to some extent in past annual reports about what discount rate to use. We basically think in terms of the long-term government rate. And there may be times, when in a very — because we don't think we're any good at predicting interest rates, but probably in times of very — what would seem like very low rates — we might use a little higher rate.**

But we don't put the risk factor in, per se, because essentially, the purity of the idea is that you're discounting future cash. And it doesn't make any difference whether cash comes from a risky business or a safe business — so-called safe business. So, the value of the cash delivered by a water company, which is going to be around for a hundred years, is not different than the value of the cash derived from some high-tech company, if any, that — (laughter) — you might be looking at. It may be harder for you to make the estimate. And you may, therefore, want a bigger discount when you get all through with the calculation. But up to the point where you decide what you're willing to pay — you may decide you can't estimate it at all. I mean, that's what happens with us with most companies.

But we believe in using a government bond-type interest rate. We believe in trying to stick with businesses where we think we can see the future reasonably well — you never see it perfectly, obviously — but where we think we have a reasonable handle on it. And we would differentiate to some extent. We don't want to go below a certain threshold of understanding. So, we want to stick with businesses we think we understand quite well, and not try to have the whole panoply with all different kinds of risk rates, because, frankly, we think that'd just be playing games with numbers. I mean, we — I don't think you can stick something — numbers on a highly speculative business, where the whole industry's going to change in five years, and have it mean anything when you get through.

If you say I'm going to stick an extra 6 percent in on the interest rate to allow for the fact — I tend to think that's kind of nonsense. I mean, it may look mathematical. But it's mathematical gibberish in my view. You better just stick with businesses that you can understand, use the government bond rate. And when you can buy them — something you understand well — at a significant discount, then, you should start getting excited.

43. "Outside information" in annual reports

But I'm more curious — because I think I know what you're reading for — if there are any disclosures — any further disclosures — that you would like to see companies make in their financial reporting, or that the SEC require in financial reporting or proxies or other communications with their shareholders? And that would be for both you and for Mr. Munger.

WARREN BUFFETT: Yeah. **The main thing that they can't mandate in annual reports: I really like to have — I like to know as much as I can about the person that's running it and how they think about the business and what's really going on in the business. In other words, I would like to have a report that would be identical to what — if I owned half of a company but was away for a year, and I had a partner who owned the other half — when I came back, that he would tell me about what had taken place during the past year and what he foresaw coming up and all of that.** What I'm trying to do as I read reports, A, I like to understand just generally what's going on in all kinds of businesses.

If we own stock in a company and in an industry, and there are eight other companies that are in the same industry, I want to own or be on the mailing list for the reports for the other eight, because I can't understand how my company is doing unless I understand what the other eight are doing. I want to have the perspective of, in terms of market share, what's going on in the business or their margins or the trend of margins, all kinds of things that I can't get unless I know — I can't be an intelligent owner of a business unless I know what all the other businesses in that industry are doing. And so, I try to get that information out of a report. If I'm thinking about investing in a specific company, I try to size up their business and the people that are running it.

And over the years, I have found reading a lot of reports to be quite useful in terms of making business decisions at Berkshire. **If we own all of a business, I want to own shares in all of the competitors just to keep track of what's going on. And I want to be able to intelligently evaluate how our managers are doing that. And I can't do that unless I know the industry backdrop against which they're working. It's amazing, you know, what — how well you can do in investing, really, with what I would call outside information. I find inside information — I'm not sure how useful that is.**

But outside information — there's all kinds of information around, as to businesses. And you don't have to understand all of them. You just have to understand the ones that you're thinking about getting in. And you can do it, if you just — nobody will do it for you. You can't read — in my view — you can't read Wall Street reports and get anything out of them. You have to do it yourself and get your arms around it. I don't think we've ever gotten an idea, you know, in 40 years from a Wall Street report. But we've gotten a lot of ideas from annual reports.

CHARLIE MUNGER: What I find is that it takes a long time to read the annual report even if it's a comparatively simple business, because if you really are trying to understand it, it's not a bit easy.

WARREN BUFFETT: Yeah. I would say that, on average, in a business we're really interested in, even though we know what to skip, to some extent, and what to read, I mean, it's going to be 45 minutes or an hour on a report. And if there are six or eight companies in the industry, that's going to be six or eight hours, perhaps, and then their quarterlies and a lot of other — I mean, it — the way you learn about businesses is by absorbing information about them, thinking, deciding what counts and what doesn't count, relating one thing to another. And, you know, that's the job. And you can't get that by looking at a bunch of little numbers on a chart bobbing up and down about a — or reading, you know, market commentary and periodicals or anything of the sort. That just won't do it. You've got to understand the businesses. That's where it all begins and ends.

Downsizing

CHARLIE MUNGER: **Well, if you put it in reverse, you'd say, name a business that has been ruined because it was over-downsized. I cannot think of a single one. But if you asked me to name businesses that were half-ruined, or ruined, by bloat, I mean, I could just rattle off name after name after name.** It's gotten fashionable to assume that downsizing is wrong. Well, it may have been wrong to let the business get so fat that it eventually had to downsize. But if you've got way more people than are needed in the business, I see no social benefit in having people sit around half employed or unemployed.

P&C vs Investing

It's a lot like investments. If you feel you have to invest every day, you're going to make a lot of mistakes. It just — it isn't that kind of a business. You have to wait until you get the fat pitch. And in insurance, it's similar. You do not — if we had a budget for premium volume for our insurance companies, it would be the dumbest thing we could do, because they would meet the budget.

You'll rationalize it, so you think it's smart. But you will do it. **You won't just sit there and write the shareholders at the end of the year and say, you know, "We asked you for $300 million last year. And we'd like to report that it's**

all safely in a bank account at Citicorp." It just doesn't work that way. So they will go out and do something. People don't like to sit around all day and do nothing.

Problems

But their fundamental problem — and Steve Wolf has said this — the new CEO of USAir — the fundamental problems are there. And they either address and correct those fundamental problems, or those problems will address and correct them. (Laughter)

11. Why $7B of insurance float is better than $7B of cash

WARREN BUFFETT: Oh, yeah, the question about the insurance business, the intrinsic value. I would say this. We have — I'm not going to give you a precise answer, but I will tell you this. **We have 7 billion, presently, of float. That's the money we're holding that belongs to someone else but that we have the use of. Now, if I were asked, would I trade that for $7 billion and not have to pay tax on the gain that would result if I did that, but I would then have to stay out of the insurance business forever — total forever non-compete clause of any kind in insurance — would I accept that? And the answer is no.**

Now, that is not because I would rather have 7 billion of float than 7 billion of net proceeds of free money. It's because I expect the 7 billion to grow. And if I'd made that trade — that I'm just suggesting now — if I'd made that 27 years ago and said, "Will you take 17 million for the float you have, no tax to be paid, the float for which you just paid 8-million-7 when we bought the companies, and gotten out of the insurance business," I might've said yes in those days, but it would've —

WARREN BUFFETT: That's probably true in this case. I'm not sure about other cases. But it would've been a terrible mistake. It would've been a mistake to do it 10 or 12 years ago with 300 million. It is not worth $7 billion to us to forego being in the insurance business forever at Berkshire Hathaway. Even though it would all be, you know, it would be — if it were nontaxed profits, so we got the full 7 billion, pure addition to equity — we would not take it. And we wouldn't even think about it very long. So as Charlie says, that is not the answer that we would've given some time back. But it's a very valuable business. It has to be run right. I mean, GEICO has to be run right. The reinsurance business has to be run right, National Indemnity, the Homestate Company. They all have to be run right. And it's not automatic.

13. Don't wait for downturn to buy a great company

AUDIENCE MEMBER: I had one quick question —you said, if you have three great companies, wonderful businesses, they could last you a lifetime. And I have — one thing that struck me in a way that — (inaudible) — great businesses get pounded down. And then you bet big on them, like American Express and Disney at one time. And my question is, I have capital to invest, but I haven't yet invested it. I have three great companies, which I've identified: Coca-Cola, Gillette, and McDonald's. And my question is, if I have a lifetime ahead of me, where I want to keep an investment for more than 20 or 30 years, is it better to wait a year or two to see if one of those companies stumble, or to get in now and just stay with it over a long time horizon?

WARREN BUFFETT: Yeah. Well, I won't comment on the three companies that you've named. **But in general terms, unless you find the prices of a great company really offensive, if you feel you've identified it — And by definition, a great company is one that's going to remain great for 30 years.** If it's going to be a great company for three years, you know, it ain't a great company. I mean, it — (Laughter)

So, you really want to go along with the idea of something that, if you were going to take a trip for 20 years, you wouldn't feel bad leaving the money in with no orders with your broker and no power of attorney or anything, and you just go on the trip. And you know you come back, and it's going to be a terribly strong company. I think it's better just to own them. I mean, you know, we could attempt to buy and sell some of the things that we own that we think are fine businesses. But they're too hard to find. I mean, we found See's Candy in 1972, or we find, here and there, we get the opportunity to do something. But they're too hard to find.

So, to sit there and hope that you buy them in the throes of some panic, you know, that you sort of take the attitude of a mortician, you know, waiting for a flu epidemic or something, I mean — (laughter) — it — I'm not sure that will be a great technique.

I mean, it may be great if you inherit. You know, Paul Getty inherited the money at the bottom, in '32. I mean, he didn't inherit it exactly. He talked his mother out of it. But — (laughter) — it's true, actually. But he benefitted enormously by having access to a lot of cash in 19 — in the early '30s — that he didn't have access to in the late '20s. And so, you get some accidents like that. But that's a lot to count on. And you know, if you start with the Dow at X, and you think it's too high, you know, when it goes to 90 percent of X, do you buy? Well, if it does, and it goes to 50 percent of X, it gets — you know, you never get the benefits of those extremes anyway, unless you just come into some accidental sum of money at some time.

So, I think the main thing to do is find wonderful businesses. Is Phil Carret here? We've got the world —there's the hero of investing. Phil, would you stand up? Phil is 99. He wrote a book on investing in 1924 ["Buying a Bond"]. (Applause) Phil has done awfully well by finding businesses he likes, and sticking with them, and not worrying too much about what they do day to day. There's going to be — I think there's going to be an article in the Wall Street Journal about Phil on May 28th, and I advise you all to read it. And you'll probably learn a lot more than by coming to this meeting, but — It's that approach of buying businesses — I mean, let's just say there was no stock market. And the owner of the best business in whatever your hometown is came to you and said, "Look it, you know, my brother just died, and he owned 20 percent of the business. And I want somebody to go in with me to buy that 20 percent.

"And the price looks a little high, maybe, but this is what I think I can get for it. You know, do you want to buy in?" **You know, I think, if you like the business, and you like the person that's coming to you, and the price sounds reasonable, and you really know the business, I think, probably, the thing to do is to take it and don't worry about how it's quoted.** It won't be quoted tomorrow, or next week, or next month. You know, I think people's investment would be more intelligent, you know, if stocks were quoted about once a year. But it isn't going to happen that way, so — And if you happen to come in to some added money at some time when something dramatic has happened — I mean, we did well back in 1964, because American Express ran into a crook. You know, we did well in 1976, because GEICO's managers and auditors didn't know what their loss reserves should've been the previous couple of years. So, we've had our share of flu epidemics. But you don't want to spend your life — (laughs) — waiting around for them.

Predictability

WARREN BUFFETT: I think they're far easier to predict than most businesses. I think I can come closer to telling you the future of virtually all of the businesses we have, and not just because we have them — I mean, if they belonged to somebody else — than if I took the Dow 30, excluding the ones we own, or you know, the first 100 companies alphabetically on the New York Stock Exchange.

I think ours are way easier to predict. There are fair — they tend to be fundamental things, fairly simple. Rate of change is not fast, so I feel pretty comfortable. I think, when you look at Berkshire five years from now, the businesses we have now will be performing pretty much as we've anticipated at this time. I hope there are some new ones, and I hope they're big ones. But I don't think that we'll have had lots of surprises in the present ones.

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Price for Good Businesses

Generally speaking, I think if you're sure enough about a business being wonderful, it's more important to be certain about the business being a wonderful business than it is to be certain that the price is not 10 percent too high or 5 percent too high or something of the sort. And that's a philosophy that I came slowly to. I originally was incredibly price conscious.

Understanding a Business

And really, you know, it might be a little too much to expect that somebody would understand every business in the world. And we find some that are much harder for us to understand. **And when I say understand, my idea of understanding a business is that you've got a pretty good idea where it's going to be in ten years.** And I just can't get that conviction with a lot of businesses, whereas I can get it with relatively few.

Opportunity Cost

CHARLIE MUNGER: I would argue that one filter that's useful in investing is the simple idea of opportunity cost. If you have one opportunity that you already have available in large quantity, and you like it better than 98 percent of the other things you see, well, you can just screen out the other 98 percent because you already know something better.

So the people who have a lot of opportunities tend to make better investments than people that don't have a lot of opportunities. And people who have very good opportunities, and using a concept of opportunity cost, they can make better decisions about what to buy. With this attitude, you get a concentrated portfolio, which we don't mind. That practice of ours, which is so simple, is not widely copied. I do not know why. Now, it's copied among the Berkshire shareholders. I mean, all of you people have learned it.

WARREN BUFFETT: There are several possible answers to that question. (Laughter) The attitude, though — I mean, if somebody shows us a business, you know, the first thing that goes through our head is would we rather own this business than more Coca-Cola? Would we rather own it than more Gillette? It's crazy not to compare it to things that you're very certain of. There's very few businesses that we'll find that we're certain of the future about as companies such as that. And therefore, we will want companies where the certainty gets close to that. And, then, we'll want to figure that we're better off than just buying more of those.

17. "It's not share of market. It's share of mind that counts"

AUDIENCE MEMBER: Mike Assail (PH) from New York City. Could you explain a little more about what you call the "mind of the consumer" and the "nature of the product" and explain how you actually apply these concepts to find the companies with the growing demand and the best investment potential? And thank you for being two of the greatest professors I've ever had.

WARREN BUFFETT: Thanks. (Applause) You know, what you really — when you get into consumer products, you're really interested in finding out — or thinking about — what is in the mind of how many people throughout the world about a product now, and what is likely to be in their mind five or ten or 20 years from now? But everybody has something in their mind about Coca-Cola. And overwhelmingly, it's favorable. It's associated with pleasant experiences.

Now, part of that is by design. I mean, it is where you are happy. It is at Disneyland, at Disney World. And it's at ballparks. And it's every place that you're likely to have a smile on your face, including the Berkshire Hathaway meeting I might add. (Laughter) And that position in the mind is pretty firmly established. And it's established in close to 200 countries around the world with people. A year from now, it will be established in more minds. And it will have a slightly, slightly, slightly different overall position. In ten years from now, the position can move just a little bit more. It's share of mind. It's not share of market. It's share of mind that counts.

Disney, same way. **Disney means something to billions of people. And if you're a parent of a couple young children and you got 50 videos in front of you that you can buy, you're not going to sit down and preview an hour and a half of each video before deciding what one to stick in front of your kids. You know, you have got something in your mind about Disney. And you don't have it about the ABC Video Company.** Or you don't even have it about other — you don't have it about 20th Century. You know, you don't have it about Paramount. So that name, to billions of people, including lots of people outside this country, it has a meaning. And that meaning overwhelmingly is favorable. It's reinforced by the other activities of the company.

And just think of what somebody would pay if they could actually buy that share of mind, you know, of billions of people around the world. You can't do it. You can't do it by a billion dollar advertising budget or a $3 billion advertising budget or hiring 20,000 super salesmen. So you've got that. Now, the question is what does that stand for five or ten or 20 years from now? You know they'll be more people. You know they'll be more people that have heard of Disney. And you know that there will always be parents that are interested in having something for their kids to do. And you know that kids will love the same sort of things.

But that position in the mind is what counts with a consumer product. And that means you have a good product — a very good product — it means you may need tons of infrastructure, because you've got to have that — I had a case of Cherry Coke awaiting me at the top of the Great Wall when I got there in China. Now that — you've got to have something there so that the product is there when people want it. But Kodak probably does not have the same place in people's mind worldwide quite as it had 20 years ago. I mean, people didn't think of Fuji in those days, we'll say, as being in quite the same place.

And, then, Fuji took the Olympics, as I remember, in Los Angeles. And they just — they put them — they pushed their way to more of a parity with a Kodak. And you don't want to ever let them do that.

And that's why you can see a Coca-Cola or a Disney and companies like that doing things that you think, well, this doesn't make a hell of a lot of sense. You know, if they didn't spend this $10 million, wouldn't they still sell as much Coca-Cola?

But, you know, that — I quoted from that 1896 report of Coca-Cola and the promotion they were doing back then to spread the word. You never know which dollar's doing it. But you do know that everybody in the world, virtually, has heard of your product. Overwhelmingly, they've got a favorable impression on them and the next generation's going to get it. So that's what you're doing with consumer products.

CHARLIE MUNGER: Yeah. I think the See's Candy example has an interesting teaching lesson for all of us.

Warren said we were — it's the first time we really stepped up for brand quality. And it was a very hard jump for us. We'd been used to buying dollar bills for fifty cents. And the interesting thing was that if they had demanded an extra $100,000 for the See's Candy company, we wouldn't have bought it. And that was after Warren had been trained under the greatest professor of his era, and had worked 90 hours a week. Absorbing everything in the world. I mean, we just didn't have minds well enough trained to make an easy decision right. And by accident, they didn't ask the extra $100,000 for it. And we did buy it. And as it succeeded, we kept learning. I think that shows that the name of the game is continuing to learn. And even if you're very well-trained and have some natural aptitude, you still need to keep learning.

LEAPS

I don't think people — once they start focusing on short-term price behavior, which is the nature of buying calls, or LEAPS, or speculating in index futures, once you start concentrating on that, I think you're very likely to take your eye off the main ball, which is just valuing businesses. I don't recommend it. If you have X and you think you're going to be way happier when you've got 2X, it's probably not true.

You really ought to enjoy where you are at a point. And if you can make, you know, if you can make 12 or 15 percent a year, and you desire to save, and you like piling it up, you know, it'll all come in time. And why, you know, why risk losing what you need, you know, and have, for what you don't need and don't have? It's never made a lot of sense to us.

Disconfirming Evidence

And State Farm was started, I believe, in the '20s, by a fellow in Bloomington, Illinois with no capital to speak of, no agency force initially, and started as a mutual company, no incentive, I mean, no stock options, no capital invested where he could become a billionaire if he built the business up or anything. So here this company starts without any of the capitalist incentives that are we are taught are essential to a business growing, and in a huge industry, becomes the dominant player — has more than twice the market share of Allstate, the second player — becomes the dominant company against these extremely entrenched competitors with great distribution systems and loads of capital.

You know, **Darwin used to say that any time he got any evidence that flew in the face of his previous convictions, he had to write it down in the first 30 minutes or the mind was such that it would reject contrary evidence to cherished beliefs.** And certainly, there's some cherished beliefs around business schools that might, at least, find some interesting aspects in studying how a company could become the third largest company in net worth in the country with no apparent advantage going in.

WARREN BUFFETT: Yeah. Somebody would — you would say somebody had to do something very right. But the question — I don't know anybody studying what they did that was right. You know, they don't want to because it doesn't fit the pattern. And you know, when something like a State Farm happens in this world, you should try to understand it. When something like a GEICO happens in this world, you should try to understand it.

Ben Graham

WARREN BUFFETT: **I enjoyed making money more than Ben. I mean, candidly. With Ben, it just — it really was incidental, at least by the time I knew him. It may have been different when he was younger. But it just didn't — the process didn't — of the whole game did not interest him more than a dozen other things may have interested him. With me, I just find it interesting. And therefore, you know, I've spent way more — a way higher percentage of my time thinking about investing and thinking about businesses. I've probably thought way more about businesses than Ben ever did. He had other things that interested him.** So I've pursued the game a little — quite a bit — differently than he did. And therefore, measuring the record is really — the two records — it's not a proper measurement. I mean, he was doing victory laps while I still thought I was out there running against, you know, the whole field.

CHARLIE MUNGER: But Graham had some blind spots, partly of sort an ethical professorial nature. He was looking for things to teach that would work for every man, that any intelligent layman could learn and do well. Well, if that's the limitation of what you're looking for, they'll be a lot of reality you won't go into, because it's too hard to figure out and too hard to explain. Buffett, if there was money in it, had no such restriction. (Laughter)

WARREN BUFFETT: Yeah. **Ben sort of thought it was cheating if we went out and talked to the management, because he just felt that the person who read his book, you know, living in Pocatello, Idaho, could not go out and**

meet the management. So he didn't — and we didn't do it. I mean, when I worked for Graham-Newman, I don't think I ever visited a management in the 21 months I was there. He just —

But, you know, he wasn't sure whether it would be useful, anyway. But if it would be useful, you know, that meant that his book was not all that was needed, that you had to add something to it. **I found it fun to go out and talk about their businesses with people, or to check with competitors, or suppliers, or customers, and all that. But — Ben didn't think there was anything wrong with that. He just felt that if you had to do that, then his book was not the complete answer. And he didn't really want to do anything that the reader of his book couldn't do if he was on a desert island, you know, basically, with just one line to a broker.**

CHARLIE MUNGER: But if you stop to think about it, Graham was trying to play the game of "Pin the Donkey," wearing very dark glasses. And Warren, of course, would use the biggest search light he could find.

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WARREN BUFFETT: Yeah. Well, the best thing to do is buy a stock that you don't ever want to sell. I mean — and that's what we're trying to do. You may sell if you believe the valuations between different kinds of markets are somewhat out of whack. And, you know, we have done a little trimming last year in that manner. But that could well be a mistake. I mean the real thing to do with a great business is just hang on for dear life.

WARREN BUFFETT: And incidentally, the ideal purchase is to find — is to have something that you already liked be selling at a price where you feel like buying more of it. I mean, we probably should have done more of that in the past in some situations. But that's the beauty of marketable securities. You really do — if you're in a wonderful business, you do get a chance, periodically, maybe to double up in it, or something of the sort. If the market — if the stock market were to sell a lot cheaper than it is now, we would probably be buying more of the businesses that we already own. They would certainly be the first ones that we would think about. They're the businesses we like the best.

23. "What is important and what is knowable?"

We try to think about two things. We try to think about things that are important and things that are knowable. Now, there are things that are important that are not knowable. In our view, those two questions that you raised fall in that. There are things that are knowable but not important. We don't want to clutter our minds up with those. So we say, "What is important and what is knowable?" And what among the things that fall within those two categories can we translate into some kind of an action that is useful for Berkshire.

And we really — there are all kinds of important subjects that Charlie and I, we don't know anything about, and therefore we don't think about them. **So we have — our view about what the world will look like over the next ten years in business or competitive situations, we're just no good. We do think we know something about what Coca-Cola's going to look like in ten years, or what Gillette's going to look like in ten years, or what Disney's going to look like in ten years, or what some of our operating subsidiaries are going to look like in ten years.**

We care a lot about that. We think a lot about that. We want to be right about that. If we're right about that, the other things get to be — you know, they're less important. And if we started focusing on those, we would miss a lot of big things. I've used this example before, but Coca-Cola went public in, I think, it was 1919. And the first year one share cost $40. The first year it went down a little over 50 percent. At the end of the year, it was down to $19. There were some problems with bottler contracts. There's problems with sugar. Various kinds of problems.

If you'd had perfect foresight, you would have seen the world's greatest depression staring you in the face, when the social order even got questioned. You would have seen World War II. You would have seen atomic bombs and hydrogen bombs. You would have seen all kinds of things. And you could always find a reason to postpone why

you should buy that share of Coca-Cola. But the important thing wasn't to see that. The important thing was to see they were going to be selling a billion eight-ounce servings of beverages a day this year. Or some large number. And that the person who could make people happy a billion times a day around the globe ought to make a few bucks off doing it.

And so that $40, which went down to $19, I think with dividends reinvested, has to be well over $5 million now. And if you developed a view on these other subjects that in any way forestalled you acting on this more important, specific narrow view about the future of the company, you would have missed a great ride. So that's the kind of thing we focus on.

24. Praise for Value Line's "perfect snapshot"

Mr. Buffett, considering the large amounts of demands on your time, how do you go about

reviewing the entire spectrum of choices in the equity markets?

WARREN BUFFETT: But I don't mind it at all, because the truth is that we get Value Line. Charlie and I both get it in our respective offices, but we get incredible value out of it because it give us the quickest way to see a huge number of the key factors that tell us whether we're basically interested in the company. And it also gives us a great way — good way — of sort of periodically keeping up-to-date. **Value Line has 1,700 or so stocks they cover, and they do it every 13 weeks. So it's a good way to make sure that you haven't overlooked something if you just quickly review that. But the snapshot it presents is an enormously efficient way for us to garner information about various businesses.** We don't care about the ratings. I mean that doesn't make any difference to us. We're not looking for opinions. We're looking for facts.

But I have yet to see a better way, including fooling around on the internet or anything, that gives me the information as quickly. I can absorb the information on — about a company — most of the key information you can get — and probably doesn't take more than 30 seconds in glancing through Value Line, and I don't have any other system that's as good.

CHARLIE MUNGER: **Well, I think the Value Line charts are a human triumph. It's hard for me to imagine a job being done any better than is done in those charts. An immense amount of information is put in very usable form. And if I were running a business school we would be teaching from Value Line charts.**

WARREN BUFFETT: And when Charlie says the charts, he does not mean just the chart of the price behavior. He means all that information that really is listed under the charts that —

CHARLIE MUNGER: Oh yeah.

WARREN BUFFETT: The detailed financial information. You can run your eye across that. The chart of the price action doesn't mean a thing to us, although it may catch our eye, just in terms of businesses that have done very well over time. But we — price action has nothing to do with any decision we make. Price itself is all-important, but whether a stock has gone up or down, or what the volume is, or any of that sort of thing, that is — as far as we're concerned, you know, those are chicken tracks, and we pay no attention to them. But that information that's right below the chart, in those 10 lines or so — 15 lines — if you have some understanding of business, that's a — it's a perfect snapshot to tell you very quickly what kind of a business you're looking at.

26. "Wonderful companies" should buy back stock

AUDIENCE MEMBER: Yes. Bill Ackman from New York. Is there a price at which it's inappropriate for a company to use its capital to buy back its stock? Example. Coca-Cola at 40 P/E. Is that a smart place for Coke to deploy capital?

WARREN BUFFETT: Well, it sounds like a very high price when you name it in terms of a P/E to buy back the stock at that sort of number. But I would say this: Coca-Cola's been around a hundred and — what, 12 years now, and there are very few times in that 112 years, if any, when it would not have been smart for Coca-Cola to be repurchasing its shares. Coca-Cola is, in my view, among businesses that I can understand, it's the best large business in the world. I mean it is a fantastic business.

I think it — all I can tell you is, I approve of Coke repurchasing shares. I'd a lot rather have them repurchasing shares at 15 times earnings, but when I look at other ways to use capital, I still think it's a very good use of capital. And maybe the day will come when they can buy it at 20 times earnings, and if they can I hope they go out and borrow a lot of money to ton of it at those prices, and — I think we will be better off 20 years from now if Coke follows a consistent repurchase approach.

I do not think that is true for many companies. I mean I think that repurchases have become en vogue and done for a lot of silly reasons. And so I don't think everybody's repurchase of shares is well reasoned at all. You know, we see companies that issue options by the ton and then they repurchase shares much higher, you know — So there are a number that we don't approve of. When we own stock in a wonderful business, we like the idea of repurchases, even at prices that may give you nose bleeds. It generally turns out to be a pretty good policy.

CHARLIE MUNGER: Well, I think the answer is that in any company the stock could get to a price so high it would be foolish for the corporation to repurchase its shares.

WARREN BUFFETT: Sure.

CHARLIE MUNGER: And you can even get into gross abuse. Before the crash, the Insull utilities were madly buying their own shares as a way of promoting the stock higher. It was like a giant Ponzi scheme at the end. So there's all kinds of excess that possible, but the really great companies that buy at high price- earnings, that can be wise.

WARREN BUFFETT: Our interest in GEICO went from 33 percent to 50 percent without us laying out a dime, because GEICO was repurchasing its shares. And we've benefitted substantially. But we benefitted a lot more, obviously, when prices were lower. I mean we would — our interest in The Washington Post company has gone from nine and a fraction percent, to 17 and a fraction percent over the years without us buying a single share. But The Post or Coke or any number of companies don't get the bargain in repurchasing now that they used to. We still think it's probably the best use of many in many cases.

27. Berkshire insurance float has a negative cost

My question has to do with float. You said in the annual, and you've said in the past, that float has had a greater value to Berkshire than an equal amount of equity. I wondered if you could clarify that statement. Is that because the float has been generated at such a low cost relative to an imputed cost for equity, or is there something else behind that statement?

WARREN BUFFETT: No, it's because the float, which is now, we'll say, 7 billion, comes to us at a negative cost. We would not make that statement if our float was costing us a couple percent a year, even though float would then be desirable. Highly desirable. But our float is even better than that, or it has been, and so it comes to us with a cost of less than zero. It comes to us with a profit attached.

So if we were to replace — if we were to get out of the insurance business and give up the 7 billion of float and replace it with 7 billion of equity, we would have less going for us next year than under the present situation, even though our net worth would appear to be 7 billion higher. And I have said, if we were to make the decision — if we were offered the opportunity to go out of the insurance business, and that 7 billion liability would — as part of that decision — would evaporate from our balance sheet, so that our equity would go up 7 billion, with no tax implications, we would turn down that proposition.

So obviously we think that 7 billion, which is shown as a liability, when it's part of a — viewed as part of an insurance business, is not a liability at all in terms of real economic value. And of course, the key is not what the float is today, and not what the cost is today. The key is what is the float going to be 10 or 15 years from now, and what is the cost going to be 10 or 15.

35. Ignoring asset gains at Coca-Cola

WARREN BUFFETT: Yeah, well, taking the second question, for example, **with Coca-Cola, the bottling transactions are incidental to a long-term strategy which, in my view, has been enormously successful to date, and which has more successes ahead of it. But in the process of rearranging and consolidating the bottling system, and expanding to relatively undeveloped markets, there have been, and there will be, a lot of bottling transactions. And some produce large gains. Some produce small gains. I ignore those in my evaluation of Coke.**

The two important elements in Coke are unit case sales and shares outstanding. And if the shares outstanding go down and the unit case sales advance at a good clip, you are going to make money over time in Coca-Cola.

There have been transactions where people have purchased rights to various drinks. Coca- Cola's purchased some of those around the world. And when you see what is paid for a million or 100 million unit cases of a business, and then you think to yourself that maybe Coke will add a billion and a half cases a year, that's a real gain in value. It's a dramatic gain in value. And that is what counts, in terms of the Coca-Cola Company. If you think the Coca-Cola

Company's going to sell some multiples of its present volume 15 or 20 years from now, and you think there'll be a lot fewer shares outstanding, you've gone about as far as you need to go. But I would pay no attention to asset gains. I would just take those out of the picture. Coca-Cola's earnings are very easy to figure out. Just figure out what they're, you know, what they're earning per case from operations, and you'll see over the years the earnings per case go up. And the cases go up and the shares go down. And it doesn't get much more complicated than that.

GEICO, the key — I mean the same way. It's policies in force and underwriting experience per policy. And that is exactly the way, as noted in the annual report, we pay people there. We pay them, from the bottom to the very top, based on what happens with those two variables. And we don't talk about earnings per share at GEICO, and we don't talk about investment income. We don't get off the track, because there are two things that are going to determine what kind of business that GEICO is over a long period of time. And policies at GEICO are unit cases at Coca-Cola.

37. Benjamin Graham and how Buffett would teach investing

My question isn't what sources, such as Graham or Fisher or Mr. Munger's talks, you would point people that are teaching business valuation to, but do you have any counsel about the techniques of teaching business valuation?

WARREN BUFFETT: Well, I was lucky. I had a sensational teacher in Ben Graham, and we had a course there, there's at least one fellow out in the audience here that attended with me. And Ben made it terribly interesting, because what we did was we walked into that class and we valued companies. And he had various little games he would play with us. **Sometimes he would have us evaluate company A and company B with a whole bunch of figures, and then we would find out that A and B were the same company at different points in its history, for example**. And then there were a lot of little games he played to get us to think about what were the key variables and how could we go off the track.

I remember one time Ben met with Charlie and me and about nine or so other people down in San Diego in 1968 or so, when he gave all of us a little true/false test, and we all thought we were pretty smart — we all flunked. But that was his way of teaching us that a smart man playing his own game and working at fooling you could do a pretty good job at it.

But I would, you know, if I were teaching a course on investments, there would be simply one valuation study after another with the students, trying to identify the key variables in that particular business, and evaluating how predictable they were first, because that is the first step. If something is not very predictable, forget it. You know, you don't have to be right about every company. You have to make a few good decisions in your lifetime. But then when you find — the important thing is to know when you find one where you really do know the key variables — which ones are important — and you do think you've got a fix on them.

Where we've been — where we've done well, Charlie and I made a dozen or so very big decisions relative to net worth, but not as big as they should have been. And we've known we were right on those going in. I mean they just weren't that complicated. And we knew we were focusing on the right variables and they were dominant. And we knew that even though we couldn't take it out to five decimal places or anything like that, we knew that in a general way we were right about them. And that's what we look for. The fat pitch. And that's what I would be teaching — trying to teach students to do. And I would not try to teach them to think they could do the impossible.

CHARLIE MUNGER: Yes. If you're planning to teach business valuation, and what you hope to do is teach the way people teach real estate appraising. So you can take any company, and your students, after studying your course, will be able to give you an appraisal of that company, which will indicate, really, its future prospects compared to its market price, I think you're attempting the impossible.

Technology

I could spend all my time thinking about technology for the next year and I wouldn't be the hundredth or the thousandth or the 10,000th smartest guy in the country in looking at those businesses. So that is a seven or eight foot bar that I can't clear. There are people that can clear it, but I can't clear it. And no matter how I train, I can't clear it. So, the fact that there will be a lot of money made by somebody doesn't bother me, really. And I mean there may be a lot of money made by somebody in cocoa beans, but I don't know anything about them. And I think it would be a very valid criticism if Charlie and I — if it were possible that Charlie and I, by spending a year working on it, could become well enough informed so that our judgment would be better than other people's, but that wouldn't happen. And it would be a waste of time. It's much better for us to swing at the easy pitches.

9. Checklist for selecting stocks

Could you explain the criteria you look at when selecting your stocks?

WARREN BUFFETT: We look at it — the criteria for selecting a stock is really the criteria for looking at a business. We are looking for a business we can understand. That means they sell a product that we think we understand, or we understand the nature of the competition, what could go wrong with it over time. And then when we find that business we try to figure out whether the economics of it means the earning power over the next five, or 10, or 15 years is likely to be good and getting better or poor and getting worse. But we try to evaluate that future stream. And then we try to decide whether we're getting in with some people that we feel comfortable being in with.

And then we try to decide what's an appropriate price for what we've seen up to that point. And as I said last year, what we do is simple but not necessarily easy. The checklist that is going through our mind is not very complicated. Knowing what you don't know is important, and sometimes that's not easy. And knowing the future is definitely — it's impossible in many cases, in our view, and it's difficult in others. And sometimes it's relatively easy, and we're looking for the ones that are relatively easy. And then when you get all through you have to find it at a price that's interesting to you, and that's very difficult for us now. Although there have been periods in the past where it's been a total cinch.

And that's what goes through our mind. **If you were thinking of buying a service station, or a dry cleaning establish, or a convenience store in Omaha to invest your life savings in and run as a business, you'd think about the same sort of things. You'd think about the competitive position and what it would look like five or 10 years from now, and how you were going to run it, and who was going to run it for you, and how much you had to pay. And that's exactly what we think of when we look at a stock, because the stock is nothing other than a piece of a business.**

Selling at the Top

That's happened many times. I mean, we think that anything we sell should go up subsequently, because we own good businesses and we may sell them because we need money for something else, but we still think they're good businesses, and we think good businesses are going to be worth more over time. So everything I sold in the past, virtually that I can think of, has gone on to sell at a lot more — for a lot more money. And I would expect that would continue to be the case.

That's not a source of distress. But I must say that selling the Disney was a mistake, and actually the ad agencies had done very well since we sold them, too. Now, maybe some of that money went into Coca-Cola or something else, so I don't worry about that. **I would worry, frankly, if I sold a bunch of things right at the top, because that would indicate that, in effect, I was practicing the bigger fool-type approach to investing, and I don't think that can be practiced successfully over time.**

I think the most successful investors, if they sell at all, will be selling things that end up going a lot higher, because it means that they've been buying into good businesses as they've gone along. But it is instructive to look at — to do postmortems on everything and say — as long as you don't get carried away with it. But every acquisition decision, that kind of thing, you know, there should be postmortems. Now, most companies don't like to do postmortems on their capital expenditures.

Market Valuation

In terms of — overvalue — the question whether the market's overvalued, generally, it's simply as we said last year here in the annual report. It's not — the general market is not overvalued if two conditions are met, which is — in our view — which is that interest rates remain at or near present levels or go lower or — and that corporate profitability in the U.S. stay at the present — or close to the present — levels, which are virtually unprecedented. If the two conditions are met, I think it's not overvalued. And if either of the conditions is breached in an important way, I think it will turn out to be overvalued. And I don't know the answer, which is why I put it in the form that I did. It's very tough at any given time to look forward and know what level of valuation is justified.

Maintenance Capex

WARREN BUFFETT: Well, if you look at a company such as Gillette or Coke, you won't find great differences between their depreciation — forget about amortization for the moment — but depreciation and sort of the required capital expenditures. If we got into a hyperinflationary period or — I mean, you can find — you can set up cases where that wouldn't be true. **But by and large, the depreciation charge is not inappropriate in most companies to use as a proxy for required capital expenditures. Which is why we think that reported earnings plus amortization of intangibles usually gives a pretty good indication of earning power**, and — I don't — I've never given a thought to whether Gillette needs to spend a hundred million dollars more, a hundred million dollars less, than depreciation in order to maintain its competitive position. But I would guess the range is even considerably less than that versus its recorded depreciation.

42. How Phil Fisher's "scuttlebutt" method changed Buffett's life

AUDIENCE MEMBER: My name is Travis Heath (PH). I'm from Dallas, Texas. And my question regards what Phil Fisher referred to as "scuttlebutt." When you've identified a business that you consider to warrant further investigation —

more intense investigation — how much time do you spend commonly, both in terms of total hours and in terms of the span in weeks or months that you perform that investigation over?

WARREN BUFFETT: Well, the answer to that question is that now I spend practically none because I've done it in the past. And the one advantage of allocating capital is that an awful lot of what you do is cumulative in nature, so that you do get continuing benefits out of things that you'd done earlier.

So by now, I'm probably fairly familiar with most of the businesses that might qualify for investment at Berkshire. But when I started out, and for a long time I used to do a lot of what Phil Fisher described — I followed his scuttlebutt method. And I don't think you can do too much of it. Now, the general premise of why you're interested in something should be 80 percent of it or thereabouts. I mean, you don't want to be chasing down every idea that way, so you should have a strong presumption.

You should be like a basketball coach who runs into a seven-footer on the street. I mean, you're interested to start with; now you have to find out if you can keep him in school, if he's coordinated, and all that sort of thing. That's the scuttlebutt aspect of it. But I believe that as you're acquiring knowledge about industries in general, companies specifically, that there really isn't anything like first doing some reading about them, and then getting out and talking to competitors, and customers, and suppliers, and ex-employees, and current employees, and whatever it may be.

And you will learn a lot. But it should be the last 20 percent or 10 percent. I mean, you don't want to get too impressed by that, because you really want to start with a business where you think the economics are good, where they look like seven-footers, and then you want to go out with a scuttlebutt approach to possibly reject your original hypothesis. Or maybe, if you confirm it, maybe do it even more strongly. I did that with American Express back in the '60s and essentially the scuttlebutt approach so reinforced my feeling about it that I kept buying more and more and more as I went along.

And if you talk to a bunch of people on an industry and you ask them what competitor they fear the most, and why they fear them, and all of that sort of thing. You know, who would they use the silver bullet of Andy Grove's on and so on, you're going to learn a lot about it. You'll probably know more about the industry than most of the people in it when you get through, because you'll bring an independent perspective to it, and you'll be listening to everything everyone says rather than coming in with these preconceived notions and just sort of listening to your own truths after a while. I advise it. I don't really do it much anymore. I do it a little bit, and I talked in the annual report about how when we made the decision on keeping the American Express when we exchanged our Percs for common stock in 1994, I was using the scuttlebutt approach when I talked to Frank Olson.

I couldn't have talked to a better guy than Frank Olson. Frank Olson, running Hertz Corporation, lots of experience at United Airlines, and a consumer marketing guy by nature. I mean, he understands business. And when I asked him how strong the American Express card was and what were the strengths and the weaknesses of it, and who was coming along after it, and so on, I mean, he could give me an answer in five minutes that would be better than I could accomplish in hours and hours and hours or weeks of roaming around and doing other things. So you can learn from people. And Frank was a user of it. I mean, Frank was paying X percent to American Express for his Hertz cars. And Frank doesn't like to pay out money, so why was he paying that? And if he was paying more than he was paying on Master Charge or Visa, why was he paying more? And then what could he do about it? I mean, you just keep asking questions. And I guess Davy [Lorimer Davidson] explained that in that video we had ahead of time. I'm very grateful to him for doing that, because that was a real effort for him.

But that was really what I was doing back in 1951 when I visited him down in Washington, because I was trying to figure out why people would insure with GEICO rather than with the companies that they were already insuring with, and how permanent that advantage was. You know, what other things could you do with that advantage? And you know, there were just a lot of questions I wanted to ask him, and he was terrific in giving me the answer. It, you know, changed my life in a major way. So I have nobody to thank but Davy on that. But that's the scuttlebutt method and I do advise it.

Volatility

WARREN BUFFETT: If we have a business about which we're extremely confident as to the business result, we would prefer that it have high volatility than low volatility. We will make more money out of a business where we know where the endgame is going to be if it bounces around a lot.

I mean, for example, if people reacted to the monthly earnings of See's, which might lose money eight months out of the year and makes a fortune, you know, in November and December — if people reacted to that and therefore made its stock as an independent company very volatile, that would be terrific for us because we would know it was all nonsense. And we would buy in July and sell in January. Well, obviously, things don't behave that way. But when we see a business about which we're very certain, but the world thinks that its fortunes are going up and down, and therefore it behaves volatile — with great volatility — you know, we love it. That's way better than having a lower beta. So we think that — we actually would prefer what other people would call risk.

46. "Get more quality than you're paying for"

AUDIENCE MEMBER: And my question has to deal with kind of quality versus price. I've been to three annual meetings and I've heard great things about Coke every year. But as far as I'm aware, you have not bought any additional shares of Coke over the last three years even though the stock has done just fine. If an investor has a relatively short timeframe, say three to five years, how much weight do you think one should give to quality versus price?

WARREN BUFFETT: Well, if your timeframe is three to five years, A) I wouldn't advise it being that way. Because I think if you think you're going to get out then, it gets more toward — leaning toward the bigger fool theory.

The best way to look at any investment is, how will I feel if I own it forever, you know, and put all my family's net worth in it? But we basically believe in buying — if you talk about quality meaning the certainty that the business will perform as you expect it to perform over a period of time, so the range of possible performance is fairly narrow — you know, that's the kind of business we like to buy. And all I can say is that we like to pay a comfortable price, and that depends to some extent on what interest rates are.

We haven't found comfortable prices for the kind of businesses we like in the last year. We don't find them uncomfortable, in the sense that we want to sell them. But they're not prices at which we — we added to Coke one time about, I don't know, five years ago or thereabouts, and it's conceivable we would add again. It's a lot more conceivable we would add than subtract. But that's the way we feel about most of the businesses. We did make a decision last year that we thought bonds were relatively attractive, and we trimmed certain holdings and eliminated certain small holdings in order to make a bigger commitment in bonds.

51. McDonald's vs. Dairy Queen

Are there major differences in the investment territories fixed between McDonald's and Dairy Queen? And if yes, would you explain them?

WARREN BUFFETT: Yeah, there are major differences. **McDonald's owns, perhaps, in the area of a third of all locations worldwide. I can't tell you the exact percentage, but if they've got 23,000 outlets, they own many, many thousands of them, and operate them. And then of the remainder, they own a very high percentage and lease them to their operators, their franchisees. So they have a very large investment, on which they get very good**

returns, in physical facilities all over the world. Dairy Queen has — counting Orange Julius— 6,000-plus operations, of which 30-odd are operated by the company. And even those, some are in joint ventures or partnerships. So the investment in fixed assets is dramatically different between the two. The fixed-assets investment by the franchisee, or the person — his landlord — obviously is significant at a Dairy Queen. But it's not significant to the company as the franchisor, so that the capital employed in Dairy Queen is relatively small compared to the capital employed in McDonald's.

But McDonald's also makes a lot of money out of owning those locations and receives — Whereas Dairy Queen will, in most cases, receive 4 percent of the franchisee's sales, in terms of a royalty, at a McDonald's there's that — there's more than that percentage, plus rentals and so on. So they're two different — very different — economic models. They both depend on the success of the franchisee in the end. I mean, you have to have a good business for the franchisee to, over time, have a good business for the parent company. Both companies have that situation to deal with.

CHARLIE MUNGER: I've got nothing to add. **The 4 percent is not very much when you stop to think about providing a group of franchisees with a nationally recognized brand, and quality control, and all sorts of desirable business aids.**

WARREN BUFFETT: No, 4 percent is at the low — if you look at the whole industry — 4 percent is in the lower part of the range. But it works fine —

CHARLIE MUNGER: **Part of what attracted us was the fact that the charges to the franchisees are low at Dairy Queen.**

WARREN BUFFETT: **A successful franchisee can sell his operation for significantly more than he has invested in tangible assets. And we want it that way, obviously, because that means he's got a successful business, and it means that, over time, we will have a successful business. You want — you want a franchise operation — you want the franchise operator to make money and you want him to create a capital asset that's worth more than he's put in it.** That's the goal.

1999

11. "Right approach" to estimating Berkshire's intrinsic value

I've attempted to calculate the intrinsic value of Berkshire using the discount of present value of its total look-through earnings. I've taken Berkshire's total look-through earnings and adjusted them for normalized earnings at GEICO, the super-cat business, and General Re. Then I've assumed that Berkshire's total look-through earnings will grow at 15 percent per annum on average for 10 years, 10 years per annum for years 11 through 20. And that earnings stop growing after year 20, resulting in a coupon equaling year 20 earnings from the 21st year onward. Lastly, I've discounted those estimated earnings stream at 10 percent to get an estimate of Berkshire's intrinsic value. My question is, is this a sound method?

WARREN BUFFETT: Well, that is a very good question. Because that is the sort of way we think in terms of looking at other businesses. And I would say you've stated the approach — I couldn't state it better myself. The exact figures you want to use, whether you want to use 15 percent gains in earnings or 10 percent gains in the second decade, I would — you know, I have no comment on those particular numbers.

But you have the right approach. We would probably, in terms — we would probably use a lower discount factor in evaluating any business now, under present-day interest rates. Now, that doesn't mean we would pay that figure once we use that discount number. But we would use that to establish comparability across investment alternatives.

So, if we were looking at 50 companies and making the sort of calculation that you just talked about, we would use a — we would probably use the long-term government rate to discount it back. But we wouldn't pay that number after we discounted it back. We would look for appropriate discounts from that figure.

You've got the right approach. And then all you have to do is stick in the right numbers.

Internet Impact

And obviously, the internet is going to have an important impact on retailing. It will have a huge impact on some forms of retailing. Change them and maybe revolutionize them. I think there's some other areas where it'll — the impact will be less. But anytime we buy into a business, and anytime that we've bought in for some time, we have tried to think of what that business is going to look like in five, or 10, or 15 years. And we recognize that the internet, in many forms of retailing, is likely to pose such a threat that we simply wouldn't want to get into the business. I mean, it — not that we can measure it perfectly.

But there are a number of retailing operations that we think are threatened. And we do not think that's the case in furniture retailing. And we have three very important operations there. We could be wrong. But so far, that, you know, that would be my judgment, that furniture retailing will not be hurt. You've seen other forms of retailing where you're already starting to see some inroads being made. But it's just started. The internet is going to be a huge force in many arenas. But it'll certainly be a huge force in retailing.

But I — if I were to buy into any retailing business, whether I was buying a stock of it or buying a whole business, I would think very hard about what people are going to be trying to do to that business through the internet. And you know, it affects real estate that is dedicated to retailing. If you substitute 5 percent of the retail volume via the internet, where real estate is essentially free, you know, you can have a store in every town in the world through the internet without having any rental expense. So, I would be — I would give a lot of thought to that if I were owning a lot of retail rental space.

16. Big returns are easier with small amounts of money

Recently, at a talk at the Wharton Business School, Mr. Buffett, you indicated that — you were talking about the problems of compounding large size, which I appreciate and understand. But you indicated — you're quoted in the local paper as saying that you are confident that if you were working with a sum closer to a million dollars, that you could compound that at a 50 percent rate. For those of us who aren't saddled with the $100 billion problem — (laughter) — could you talk about what types of investments you'd be looking at and where in today's market you think significant inefficiencies exist?

WARREN BUFFETT: Yeah. I think I may have been very slightly misquoted. But I certainly said something to the effect that working — I think I talked about this group I get together every two years and how I poll that group as to what they think they can compound money at with a hundred thousand, a million, a hundred million, a billion, and other types of sums.

And I pointed out how this group of 60 or so people that I get together with every couple years — how their expectations of return would go very rapidly down this slope. It is true. **I think I can name a half a dozen people that I think could compound a million dollars — or at least they could earn 50 percent a year on a million dollars — have that as expectation, if they needed it. I mean, they'd have to give their full attention to be working on the sum**. And those people could not compound money, a hundred million or a billion, at anything remotely like that rate. I mean, there are little tiny areas which, if you follow what I said on the screen there, on that Adam Smith's interview a few years ago.

If you start with A and you go through and you look at everything and you find small securities in your area of competence that you can understand the business, I think you — and occasionally find little arbitrage situations or little wrinkles here and there in the market — I think, working with a very small sum, that there is an opportunity to earn very high returns. But that advantage disappears very rapidly as the money compounds. Because I, you know, from a million to 10 million, I would say it would fall off dramatically, in terms of the expectable rate.

Because there are little — you find very small things that, you know, you can make — you are almost certain to make high returns on. But you don't find very big things in that category today. I'll leave to you the fun of finding them yourselves. Terrible to spoil the treasure hunt. And the truth is, I don't look for them anymore. Every now and then, I'll stumble into something just by accident. But I'm not in the business of looking for them. I'm looking for things that Berkshire could put its money in, and that rules out all of that sort of thing.

CHARLIE MUNGER: Well, I would agree. But I would also say that what we did 40 or so years ago was, in some respects, more simple than what you're going to have to do. We had it very easy, compared to you. It can still be done. But it's harder now. You have to know more. I mean, just sifting through the manuals until you find something that's selling at two times earnings, that won't work for you.

18. Corporations hooked on "corrupt" stock option accounting

WARREN BUFFETT: The question about how we charge for stock options is very simple. If we look at what a company issues in options over, say, a five-year period and divide by fives — because the grants are irregular — or whatever's — if there's some reason why that seems inappropriate, we might use something else.

But we try to figure out what the average option issuance is going to be. And then we say to ourselves, "How much could the company have received for those options if they'd sold them as warrants to the public?" I mean, they can sell me options on any company in the world. I'll pay some price for an option on anything. And we would look at what the fair market value of those options would be that day if they were transferable options. Now, they aren't transferable. But they also — employees sometimes get their options repriced downward, which you don't get if you have public options.

So, we say that the cost to the shareholder of issuing the options is about what could be received if they sold — turned those options into warrants — and sold them public or sold them as options. And that's the cost. I mean, it's a compensation cost.

Wealth

- He says, "What good is health? You can't buy money with it."

WARREN BUFFETT: **The important thing, even in your work, I mean, is — to an extreme extent, it seems to me, is who you do it with. I mean, it — you can have — <u>if you're going to spend eight hours a day working, the most important isn't how much money you make, it's how you feel during those eight hours</u>, in terms of the people you're interacting with, and how interesting what you're doing is, and all of that.**

2. Technological change is bad for investments

Our own emphasis is on trying to find businesses that are predicable in a general way, as to where they'll be in 10 or 15 or 20 years. And that means we're looking for businesses that, in general, are not going to be susceptible to very much change. We view change as more of a threat into the investment process than an opportunity. That's quite contrary to the way most people are looking at equities now. But we do not get enthused about — with a few exceptions — we do not get enthused about change as a way to make a lot of money.

We try to look at — we're looking for the absence of change to protect ways that are already making a lot of money and allow them to make even more in the future. So we look at change as a threat. And whenever we look at a business and we see lots of change coming, 9 times out of 10, we're going to pass on that. And when we see something we think is very likely to look the same 10 years from now, or 20 years from now, as it does now, we feel much more confident about predicting it. Your analysis of Coca-Cola 50 years ago can pretty well serve as an analysis now. We're more comfortable in those kind of business.

Corporate Profits

I looked the other day at the Fortune 500. They earned $334 billion on — and had a market cap of 9.9 trillion at the end of the year, which would probably be at least 10 1/2 trillion now. Well, the only money investors are going to make, in the long run, are what the businesses make. I mean, there is nothing added.

But the 334 million [billion] is all that — is all the investment earns. I mean, if you want to farm, the — what the farm produces is all you're going to get from the farm. If it produces, you know, $50 an acre of net profit, you get $50 an acre of net profit. And there's nothing about it that transforms that in some miraculous form. If you own all of American — if you own all of the Fortune 500 now, if you owned a hundred percent of it, you would be making 334 billion. And if you paid 10 1/2 trillion for that, that is not a great return on investment.

Stay put in Exceptional Companies

CHARLIE MUNGER: Generally speaking, trying to dance in and out of the companies you really love, on a long-term basis, has not been a good idea for most investors. And we're quite content to sent with — to sit with our best holdings.

WARREN BUFFETT: **People have tried to do that with Berkshire over the years. And I've had some friends that thought it was getting a little ahead of itself from time to time. And they thought they'd sell and buy it back cheaper and everything. It's pretty tough to do. You have to make two decisions right. You know, you have to buy — you have to sell it right first, and then you have to buy it right later on. And usually you have to pay some tax in-between. It's — if you get into a wonderful business, best thing to do is usually is to stick with it.**

Efficient Markets and Business Valuation

WARREN BUFFETT: Thinking it's roughly efficient, though, does nothing for you in academia. You can't build anything around it. I mean, that — what people want are what they call elegant theories. And it just — it doesn't work. You know, what investment is about is valuing businesses. I mean, that is all there is to investment. You sit around and you try to figure out what a business is worth. And if it's selling below that figure you buy it.

That, to my — you can't find a course virtually in the country on how to value businesses. You can find all kinds of courses on how to, you know, how to compute beta, or whatever it may be, because that's something the instructor knows how to do. But he doesn't know how to value a business. So, the important subject doesn't get taught. And it's tough to teach. I think Ben Graham did a good job of teaching it at Columbia, and I was very fortunate to run into him many decades ago.

But if you take the average Ph.D. in finance and ask him to value a business, he's got a problem. And if he can't value it, I don't know how he can invest in it, so therefore, he — it's much easier to take up efficient market theory and say it doesn't make any difference because everybody knows everything about it, anyway. And there's no sense in trying to think about valuing businesses. If the market's efficient, it's valued them all perfectly.

15. Investing advice: start early and think for yourself

My question is, if you are starting out again today in your early 30s, what would you do differently or the same in today's environment to replicate your success? In short, Mr. Buffett, how can I make $30 billion? (Laughter)

WARREN BUFFETT: Start young. (Laughter) Charlie's always said that the big thing about it is we started building this little snowball on top of a very long hill. So we started at a very early age in rolling the snowball down. And, of course, the snowball — the nature of compound interest is it behaves like a snowball of sticky snow. And the trick is to have a very long hill, which means either starting very young or living very — to be very old.

The — you know, I would do it exactly the same way if I were doing it in the investment world. I mean, if I were getting out of school today and I had $10,000 to invest, I'd start with the As. I would start going right through companies. And I probably would focus on smaller companies, because that would be working with smaller sums and there's more chance that something is overlooked in that arena.

And, as Charlie has said earlier, it won't be like doing that in 1951 when you could leaf through and find all kinds of things that just leapt off the page at you. But that's the only way to do it. I mean, you have to buy businesses and you — or little pieces of businesses called stocks — and you have to buy them at attractive prices, and you have to buy into good businesses. And that advice will be the same a hundred years from now, in terms of investing. That's what it's all about. **And you can't expect anybody else to do it for you. I mean, people will not tell — they will not tell you about wonderful little investments. There's — it's not the way the investment business is set up.**

You've got to follow your own — you know, you've got to learn what you know and what you don't know. Within the arena of what you know, you have to just — you have to pursue it very vigorously and act on it when you find it. And you can't look around for people to agree with you. You can't look around for people to even know what you're talking about. You know, you have to think for yourself. And if you do, you'll find things.

CHARLIE MUNGER: Yeah. The hard part of the process for most people is the first $100,000. If you have a standing start at zero, getting together $100,000 is a long struggle for most people. And I would argue that the people who get there relatively quickly are helped if they're passionate about being rational, very eager and opportunistic, and steadily underspend their income grossly. I think those three factors are very helpful.

Review you Decisions

We believe in postmortems at Berkshire. I mean, we really do believe — one of the things I used to do when I ran the partnership is I contrasted all sale decisions versus all purchase decisions. It wasn't enough that the purchase decisions worked out well, they had to work out better than the sale decisions. And managers tend to be reluctant to look at the results of the capital projects or the acquisitions that they proposed with great detail a year or two earlier to a board.

And they don't want to actually stick the figures up there as to how the reality worked out against the projections. And that's human nature. But, I think you're a better doctor if you drop by the pathology department, occasionally. And I think you're a better manager or investor if you look at every one of the decisions you've made, of importance, and see which ones worked out and which ones didn't and, you know, what is your batting average. And if your batting average gets too bad, you better hand the decision making over to someone else.

Learning Investing

CHARLIE MUNGER: **I think both of us learned more from the great business magazines than we do anywhere else. It's such an easy, shorthand way of getting a vast variety of business experience, just to riffle through issue after issue after issue, covering a great variety of businesses. And if you get the mental habit of relating what you're reading to the basic structure of the underlying ideas being demonstrated, you gradually accumulate some wisdom about investing. I don't think you can get to be a really good investor over a broad range without doing a massive amount of reading. I don't think there's any one book that will do it for you.**

WARREN BUFFETT: Yeah. You might think about picking out five or 10 companies where you feel quite familiar with their products, maybe but not necessarily so familiar with their financials and all of that.

But pick out something, so at least you understand what — if you understand their products, you know what's going on in the business itself. And then, you know, get lots of annual reports. And, through the internet or something else, get all the magazine articles that have been written on it — on those companies for five or 10 years. **Just sort of immerse yourself as if you were either going to work for the company, or they'd hired you as the CEO, or you're going to buy the whole business. I mean, you could look at it in any those ways.**

And when you get all through, ask yourself, "What do I not know that I need to know?" And back many years ago, I would go around and I would talk to — I would talk to competitors, always. Talk to employees of the company, and ask those kinds of questions. That's, in effect, what I did with my friend Lorimer Davidson when I first met him at GEICO, except I started from ground zero. But I just kept asking him questions.

And that's what it really is. You know, one of the questions I would ask if I were interested in the ABC Company, I would go to the XYZ Company and try and learn a lot about it. Now, you know, there's spin on what you get, but you learn to discern it. Essentially, you're being a reporter. I mean, it's very much like journalism. And if you ask enough questions — Andy Grove has in his book — he talks about the silver bullet, you know.

You talk to the competitor and you say, "If you had a silver bullet and you could only put it through the head of one of your competitors, which one would it be and why?" Well, you learn a lot if you ask questions like that over time. And you ask somebody in the XYZ industry and you say, "If you were going to go away for 10 years and you had to put all of your money into one of your competitors — the stock of one of your competitors, not your own — which one would it be and why?" Just keep asking, and asking, and asking.

And you'll have to discount the answers you get in certain ways, but you will be getting things poured into your head that then you can use to reformulate and do your own thinking about why you evaluate this business at this or that. The accounting, you know, you just sort of have to labor your way through that. Might — I mean, you may be able to take some courses, even, in that. But the biggest thing is to find out how businesses operate.

And, you know, who am I afraid of? If we're running GEICO, you know, who do we worry about? Why do we worry about them? Who would we like to put that silver bullet through? I'm not going to tell you. (Laughter) That the — You know, it's — you keep asking those questions. And then you go to the guy they want to put the silver bullet through and find out who he wants to put the silver bullet through. It's like who wakes up the bugler, you know, in the Irving Berlin song? And that's the way you approach it. You — and you'll be learning all the time.

You can talk to current employees, ex-employees, vendors, supplies, distributors, retailers, I mean, there's customers, all kinds of people and you'll learn. But it is a — it's an investigative process. It's a journalistic process. And in the end, you want to write the story. I mean, you're doing a journalistic enterprise. And six months later, you want to say the XYZ Company is worth this amount because, and you just start in and write the story. And some companies are easy to write stories about, and other companies are much tougher to write stories about. We try to look for the ones that are easy.

WARREN BUFFETT: Yeah. If you just look, there's 1,700 of them. If you look at each page and you look at sort of what's happened in terms of return on equity, in terms of sales growth, (inaudible), all kinds of things. And then you say, "Why did this happen? Who let it happen?" You know, "What's that chart going to look the next 10 years?" Because that's what you're really trying to figure out, not the price chart, but the chart about business operation. You're trying to print the next 10 years of Value Line in your head. And there's some companies that you can do a reasonable job with, and there's others that are just too tough. But that's what the game is about. And it can be a lot of — I mean, if you have some predilection toward it, it can be a lot of fun. I mean, the process is as much fun as the conclusion that you come to.

CHARLIE MUNGER: Of course, what he's saying there, when he talks about why — that's the most important question of all. And it doesn't apply just to investment. It applies to the whole human experience.

2000

WARREN BUFFETT: Well, we think of business risk in terms of what can happen — say five, 10, 15 years from now — that will destroy, or modify, or reduce the economic strengths that we perceive currently exist in a business. In some businesses that's very — it's impossible — to figure — at least it's impossible for us to figure — and then we just — we don't even think about it then.

Inevitables

WARREN BUFFETT: Yeah. I would like to clarify one point, too. I didn't really say I regard the companies as "Inevitables." I regarded the businesses, their dominance of soft drinks, or their competitive strength in soft drinks and in razors and blades. And as a matter of fact, I actually pointed out in talking about that — a few paragraphs later, I pointed out the danger of having a wonderful business is the temptation to go into less wonderful businesses.

And to some extent, for example, Gillette's stumble in the last year or two has not been the product of their razor and blade business, but it has been some other businesses, which are not at all inevitable. And that, you know, that is always a risk. And it's a risk I pointed out, that when a company with a wonderful business gets into a mediocre business, that usually the reputation of the mediocre business prevails over the supposed invincibility of the management of the wonderful business. Anytime you can charge more for a product and maintain or increase market share against well entrenched, well-known competitors, you have something very special in people's minds. Same thing came about when the credit card came around.

Incidentally, that's one of the things we look for in businesses, is how — you know, if you see a business take a lot of adversity and still do well, that tells you something about the underlying strength of the business. The classic case was on that was — to me, is AOL. Four or five years ago — you know, I'm no expert on this, but I got the impression there for a period of time when they were having a lot of problems, that a very significant percentage of AOL's customers were mad at them. But the number of customers went up every month. And that's a terrific business. I mean, if you have a business where your customers are mad at you and you're growing, you know, that has met a certain test, in my mind, of utility.

And you might argue that American Express had that, to some degree. It wasn't that bad. But they had a lot of merchant unrest and all of that. So, occasionally, you will find that an interesting test of the strength of a business.

Valuation Horizon

But the question was, what was American Express going to look like 10 or 20 years later? And we felt very good about that. So there are no arbitrary cutoff points. But there is that focus on, how much cash will this business deliver, you know, between now and Kingdom Come? Now as a practical matter, if you estimate it for 20 years or so, the terminal values get less important. So — but you do want to have, in your mind, a stream of cash that will be thrown off over, say, a 20-year period, that makes sense discounted at a proper interest rate, compared to what you're paying today. And that's what investment's all about.

CHARLIE MUNGER: Yeah, the answer is almost the exact reverse of what you were pointing toward. A business with something glorious underneath, disguised by terrible numbers that cause cutoff points in other people's minds, is ideal for us, if we can figure it out.

WARREN BUFFETT: The answer is we will never buy anything we don't think we understand. And our definition of understanding is thinking that we have a reasonable probability of being able to asses where the business will be in 10 years.

1. Most companies hide the true cost of stock options

AUDIENCE MEMBER: My name is Steve Check. I'm from Costa Mesa, California. My question is regarding stock options. I've taken your suggestion and have been attempting to subtract stock option compensation from reported income when evaluating companies. When I read annual reports, I usually find companies estimating option costs using the Black-Scholes model. However, the assumptions going into the Black-Scholes model seem quite different from company to company. These assumptions, of course, are what is used for risk-free interest rates — quote unquote, "risk-free" interest rates, expected option lives — even though options have stated lives, and expected volatility.

Help me out a little bit. What is the best way to calculate option costs? Do you think Black- Scholes is appropriate? If so, how should we normalize the assumptions? And just one short follow-up: how can we possibly estimate future earnings for companies, when companies, such as even Microsoft last week, in response to a lower stock price, simply reissue a bunch of new options?

WARREN BUFFETT: Yeah, the — I can tell you, from some personal experience, that companies attempt to use the lowest figure they can, even though it doesn't hit the income account. So they like to make fairly short assumptions as to the life of the options, even though they're granted on a ten-year basis. Because they'll make certain assumptions about exercise date or forfeiture and so on.

I think the most appropriate way, when you've got a pattern, which you have at many companies, of what they do on options, is simply to make an educated guess as to the average option issuance that they're going to incur, or they're going to elect to do over time. And, generally, what you really want to — if you were to be precise — you would try to figure out what they could've sold those options for in the open market. Because that's the opportunity cost of giving them to the employees instead of selling the same option in the market.

I think you'll find, generally, that if you take a value of about a third, for a ten-year option, if you take a value of about a third — obviously, it depends on dividend rate and volatility and a whole bunch of things — but about a third of the market value, strike price, at the time they're issued, that's the expectable cost. We believe in using the expectable cost versus the actual cost. I mean, that is how we would look at it.

If we were issuing options at Berkshire, and we issued options on $100 million worth of stock a year, we would figure it was costing us, probably in our case, with no dividend, at least $35 million a year to issue those options. And we would figure that if we gave people $35 million in some other form of result-oriented compensation, that it would be a wash. And that is not the way most managements, of course, figure. At least that's my experience.

And we would figure we could use that 35 million in a more shareholder-oriented way and one where the employee (who) was productive would be sure of getting results, as opposed to having it be at the whims of the market.

8. "Take on the qualities of other people you admire"

It does pay to have the right models. I mean, I was very lucky, early, very early in life, that I had certain heroes — and I've continued to develop a few more, as I've gone along — and they've been terrific. And they never let me down. And it takes you through a lot. And I think that, you know, it just stands to reason that you copy, very much, the people that you do look up to, and particularly if you do it at an early enough age. **So I think, if you can influence the model — the role models — of a 5-year-old or an 8-year-old or a 10-year-old, you know, it's going to have a huge impact.**

And of course, everybody, virtually, starts out with their initial models being their parents. So they are the ones that are going to have a huge effect on them. And if that parent turns out to be a great model, I think it's going to be a huge plus for the child. I think that it beats a whole lot of other things in life to have the right models around.

And I have — like I say, even as I've gotten older, I've picked up a few more. And it influences your behavior. I'm convinced of that. And if you — you will want to be a little more, or a lot more, depending on your personality, like the person that you admire.

And I tell the students in classes, I tell them, you know, "Just pick out the person you admire the most in the class and sit down and write the reasons out why you admire them. And then try and figure out why you can't have those same qualities." Because they're not the ability to throw a football 60 yards, or run the 100 in ten flat, or something like that. They're qualities of personality, character, temperament, that are — can be emulated. But you've got to start early. It's very tough to change behavior later on. And you can apply the reverse of it. Following Charlie's theory, you can find the people that you don't like — (laughter) — and say, "What don't I like about these people?"

And then you can look — if, you know, it takes a little strength of character. But you can look inward and say, you know, "Have I got some of that in me?" and — It's not complicated. Ben Graham did it. Ben Franklin did it. And it's not complicated. Nothing could be more simple than to try and figure out what you find admirable and then decide, you know, that the person you really would like to admire is yourself. And the only way you're going to do it is take on the qualities of other people you admire.

CHARLIE MUNGER: Yeah. There is no reason, also, to look only for living models. The eminent dead are the — are, in the nature of things, some of the best models around.

11. What Buffett means when he can't "understand" a business

AUDIENCE MEMBER: Cool. In terms of these tech stocks, you say that you don't understand them. Can you say if you think — I can't imagine you not understanding something.

WARREN BUFFETT: **Oh, we understand the product. We understand what it does for people. We just don't know the economics of it 10 years from now.** That, I mean, you can understand all kinds — you can understand steel. You can understand home building. But if you look at a home builder and try and think where it's going to be in five or 10 years, the economics of it, that's another question.

I mean, it's not a question of understanding the product they turn out or the means they use to distribute it, all of those sort of things. It's the predictability of the economics of the situation 10 years out. And that — that's our problem. I would say that — and incidentally, my friend, Bill Gates, would say the same thing. And actually, Bob Noyce would've, and Bob died some years ago, but — or Andy Grove — they would say the same thing. I've taken long walks with Andy.

And they would not want to put down on paper their predictions about where 10 companies you would choose in the tech field would be in 10 years, in terms of their economics. They would say, "That's too hard."

14. Internet is good for society, bad for businesses

You know that any system of distribution is going to be affected by something that changes the economics of distribution as much as the internet does. So there's no question it'll have an impact.

CHARLIE MUNGER: Well, there's a marvelous issue buried in your question. Will the internet, by making competition so much more efficient, make business generally harder for American corporations, meaning more competitive, lower returns on capital? And my guess would be yes.

WARREN BUFFETT: Yeah. My guess would be yes, too. I would say that, on balance, for society, the internet is a wonderful thing. And for capitalists, it's probably a net negative. The internet, I mean, if you analyze it, you have to think it's much more likely that it will reduce the profitability of American business and improve it. It will improve the efficiency of American business. But all kinds of things improve the efficiency of American business without making it more profitable.

And I think that the internet is likely to fall into that category. So far, it's improved the monetized value of American business. But that will eventually follow the underlying economics of what the internet does. And I think it's way more likely to make American business, in aggregate, worth less than compared to what it would've been otherwise.

Float

I mean, if you told me I could add $50 billion of float and have a 3 percent cost to that, you know, I would take that any day over adding 10 billion at zero cost.

2001

18. Unrealistic investment expectations for pension funds

Now, interestingly enough, some of those same relationships prevailed decades ago, but you were buying stocks that were yielding you perhaps 5 percent or something like that, so that you were getting 5 percent in your pocket, plus that growth as you went along. And of course, now if you buy stocks you get 1 1/2 percent, if you're the American public, before the frictional cost. So that the same rate of growth produces a way smaller aggregate return. And some — You know, **I think stocks are a perfectly decent way to make 6 or 7 percent a year over the next 15 or 20 years.** But I think anybody that expects to make 15 percent per year, or expects their broker or investment advisor to make that kind of money, is living in a dream world.

29. Investing small amounts allows bigger opportunities

WARREN BUFFETT: Well, I would use the approach that I think I'm using now of trying to search out businesses that — where I think they're selling at the lowest price relative to the discounted cash they would produce in the future. But if I were working with a small amount of money, the universe would be huge compared to the universe of possible ideas I work with now.

You mentioned that '56 to '69 was the best period. Actually, my best period was before that. It was from right after I met Ben Graham in 19 — early 1951 — but from the end of 1950 through the next 10 years, actually, returns averaged about 50 percent a year. And I think they were 37 points better than the Dow per year, something like that. But that — I was working with a tiny, tiny, tiny amount of money.

And so, I would pour through volumes of businesses and I would find one or two that I could put $10,000 into or $15,000 into that just were — they were ridiculously cheap. And obviously, as the money increased, the universe of possible ideas started shrinking dramatically. The times were also better for doing it in that time. But I think that, if you're working with a small amount of money, with exactly the same background that Charlie and I have, and same ideas, same whatever ability we have — you know, I think you can make very significant sums.

But you — but as soon as you start getting the money up into the millions — many millions — the curve on expectable results falls off just dramatically. But that's the nature of it. You've got to — you know, when you get up to things you could put millions of dollars into, you've got a lot of competition looking at that. And they're not looking as I did when I started. When I started, I went through the pages of the manuals page by page. I mean, I probably went through 20,000 pages in the Moody's industrial, transportation, banks and finance manuals. And I did it twice. And I actually, you know, looked at every business. I didn't look very hard at some.

Well, that's not a practical way to invest tens or hundreds of millions of dollars. So I would say, if you're working with a small sum of money and you're really interested in the business and willing to do the work, you can — you will find something. There's no question about it in my mind. You will find some things that promise very large returns compared to what we will be able to deliver with large sums of money.

CHARLIE MUNGER: Well, yeah, I think that's right. A brilliant man who can't get any money from other people, and is working with a very small sum, probably should work in very obscure stocks searching out unusual mispriced opportunities. But, you know, you could — it's such a small world. It may be a way for one person to come up, but it's a long slog.

Analyzing Financials

CHARLIE MUNGER: Yeah, but that may be a peculiarity of ours. We are especially prone to get uncomfortable around financial institutions.

WARREN BUFFETT: We're quite sensitive to — risk in — whether it's in banks, insurance companies or in what they call GSEs here, in the case of Freddie and Fannie. We feel there's so much about a financial institution that you don't know by looking at just figures, that if anything bothers us a little bit, we're never sure whether it's an iceberg situation or not.

And that doesn't mean it is an iceberg situation, in the least, at banks or insurance companies that we pass. But we have seen enough of what happens with financial institutions that push one way or another, that if we get some feeling that that's going on, we just figure we'll never see it until it's too late anyway.

And when we get to that situation, it's different than buying into a company with a product or something, or a retail operation. You could spot troubles usually fairly early in those businesses. You spot troubles in financial institutions late. It's just the nature of the beast.

WARREN BUFFETT: Financial institutions don't get in trouble by running out of cash in most cases. Other businesses, you can spot that way. But a financial institution can go beyond the point — and we had banks 10 years ago that did that, en masse — but they can go beyond the point of solvency even while they still have plenty of money around.

33. Would Benjamin Graham's "cigar butt" strategy work now?

One of the central tenants in the book was that if you bought a group of stocks, say, 10 or 20, that traded at two-thirds or less than net current assets, that you would be assured of a margin of safety, coupled with a satisfactory rate of return. Today, if you were to find 10 or 20 stocks that trade at two-thirds of net current assets, would you be inclined to purchase those stocks for your own personal portfolio, not for Berkshire Hathaway?

And the second question, since I've mentioned the book, I was wondering which books that you and Mr. Munger have been reading lately and would recommend. Thank you.

WARREN BUFFETT: **Yeah, in respect to your first question, you could probably — if you found a group like that — and you won't, I don't think — you'd probably do all right buying the group. But not because the businesses themselves worked out that well over time, but because there would probably be a reasonable amount of corporate activity in a group like that, either in terms of the managements taking them private, or takeovers, or that sort of thing.**

But those sub-working capital stocks are just almost impossible to find now. **And if you got into a market where a lot of them existed, you'd probably find wonderful businesses selling a lot cheaper, too. And our inclination would be to go with a cheap, wonderful business.** I don't think you'll get — in a high market or something close to it — I don't think you'll get a lot of sub- working capital stocks anymore. **There's just too much money around to promote deals before they really get to that point. But that was a technique. It was 50 years ago.**

So I think, if you found that kind of a group and did it as a group operation, and Ben always emphasized a group operation because when you're dealing with lousy companies but you expect a certain number to be taken over and all that, you'd better have a group of them. Whereas if you deal with wonderful companies, you only need a couple. But I think, if you see that period again, we'll be very active. But it won't be in those kind of securities.

CHARLIE MUNGER: Yeah. And there's another change. In the old days, if the business stopped working, you could take the working capital and stick it in the shareholders' pockets. And nowadays, as you can tell from all the restructuring charges, when things really go to hell in a bucket, somebody else owns a lot of the working capital. The whole culture has changed. If you have a little business in France and you get tired of it, as Marks & Spencer has, the French say, "What the hell do you mean trying to take your capital back from France? There're French workers in this business."

And they don't care. They don't say, "It's your working capital. Take it back," when the business no longer works for you. They say, "It's our working capital." The whole culture has changed on that one. Not completely, but a lot from Ben Graham's day. **There're a lot of reasons why the investment idiosyncrasies of one era don't translate that perfectly into another.**

WARREN BUFFETT: That list that was published, I forget whether it was published in the 1951 edition of "Security Analysis" or the '49 edition of "Intelligent Investor," but there were a list of companies. There was Saco-Lowell, there was Marshall-Wells, there was Cleveland Worsted Mills, there was Foster Wheeler, and all those companies were sub-working capital companies selling at three or four times earnings.

And there was a — if you bought a group of stocks like that, you were going to do well. But, you know, I — you certainly don't see that in companies of any size today. **And I've seen a few lists of tech companies selling below cash. But they're determined to use that cash. And it may not be there in a year or two. It was a different breed of animal, to some extent, in Ben's list at that time.**

2002

People always want a formula. You know, they — I mean, they go to the Intelligent Investor and they think, you know, somewhere they're going to give me a little formula and then I can plug this in and I know I'll make lots of money. And it really doesn't work that way.

Confirmation Bias

WARREN BUFFETT: There's no question, the human mind — what the human being is best at doing is interpreting all new information so that their prior conclusions remain intact. I mean, that is a talent everyone seems to have mastered. And how do we guard ourselves against it? Well, we don't achieve it perfectly. I mean, Charlie and I have made big mistakes because, in effect, we have been unwilling to look afresh at something. You know, that happens.

You've hit on a terribly important point. All of us in this room want to read new information and have it confirm our cherished beliefs. I mean, it is just built into the human system.

Valuation

But you just look at — every asset class, every business, every farm, every REIT, whatever it may be, and say, "What is this thing likely to produce over time?" and that's what it's worth. It may sell at vastly different prices from time to time, but that just means one person is profiting against another, and that's not our game.

22. Life advice: take care of your most important asset

And let's assume, and I use this with — let's assume a genie appeared to you when you turned 16, and the genie said, "You get any car you want tomorrow morning, tied up in a big pink ribbon, anything you name. And it can be a Rolls Royce, it can be a Jaguar, it can be a Lexus, you name it, and that car will be there and you don't owe me a penny."

And having heard the genie stories before, you say to the genie, "What's the catch?" And of course, the genie says, "Well, there's just one. That car, which you're going to get tomorrow morning, the car of your dreams, is the only car you're ever going to get. So you can pick one, but that's it." And you still name whatever the car of your dreams is, and the next morning you receive that car.

Now, what do you do, knowing that's the only car you're going to have for the rest of your life? Well, you read the owner's manual about 10 times before you put the key in the ignition, and you keep it garaged.

You know, you change the oil twice as often as they tell you to do. You keep the tires inflated properly. If you get a little nick, you fix it that day so it doesn't rust on you. In other words, you make sure that this car of your dreams at age 16 is going to still be the car of your dreams at age 50 or 60, because you treat it as the only one you'll ever get in your lifetime. And then I would suggest to your students in Phoenix that they are going to get exactly one mind and one body, and that's the mind and body they're going to have at age 40 and 50 and 60.

And it isn't so much a question of preparing for retirement, precisely, at those ages, it's a question of preparing for life at those ages. And that they should treat the importance of taking care and maximizing that mind, and taking care of that body in a way, that when they get to be 50 or 60 or 70, they've got a real asset instead of something that's rusted and been ignored over the years. And it will be too late to think about that when they're 60 or 70. You can't repair the car back into the shape it was. You can maintain it. And in the case of a mind, you can enhance it in a very big way over time. But the most important asset your students have is themselves.

2003

30. From "cigar butts" to high-quality companies

WARREN BUFFETT: The — Charlie explained, I had learned investment, and got enormous benefit out of that learning, from a fellow who concentrated on the quantitative aspects, Ben Graham. And who didn't dismiss the qualitative aspects, but he said you could make enough money focusing on quantitative aspects, which were a more sure way of going at things and would enable you to identify the cigar butts.

He would say that the qualitative is harder to teach, it's harder to write about, it may require more insight than the quantitative. And besides, the quantitative works fine, so why try harder? And on a small scale, you know, there was a very good point to that.

EVA

Number two, though you do change — charge — subsidiaries for using capital, and believe in linking rewards to bottom line performance, Mr. Munger does not respect economic valued added as a concept. Could we have your thinking on EVA as a tool to monitor and reward corporate performance?

CHARLIE MUNGER: Well, one, you're right. **Where a business requires practically no capital, we tend to reward the management based on the earnings. The minute the business starts requiring capital we tend to put a capital factor into this compensation system.**

WARREN BUFFETT: The — you also asked about EVA. We would not dream of using something like that, although I think actually a few of our subsidiaries may use it in some way.

CHARLIE MUNGER: Yeah. **And on EVA, there are ideas implicit in that that we use. For instance, hurdle rates by — based on opportunity costs. Perfectly reasonable concept. But to us, that system, with all its labels and lingo, has a lot of baggage that we don't need. We just use the implicit, simple stuff that's buried in EVA.**

WARREN BUFFETT: Yeah. We could spend a million bucks a year on consultants to get an answer we can get in five minutes, frankly. I mean it is — it just isn't that complicated. But can you imagine a consultant coming around and saying, "I've got a one-paragraph compensation arrangement for you?"

Are they going to be able to send you a large bill for, you know, their consultancy? Of course not. So, they've got to make things complicated, and we don't believe in that. We want things that are very easy to understand, and we've just never had a problem with it.

IV

It's not scientific, but it is the intrinsic value. I mean the fact that it's fuzzy to calculate doesn't mean that it's not the proper way to think about it.

34. Short-term rates don't affect investment decisions

AUDIENCE MEMBER: My question involves interest rates. When you calculate the intrinsic value of a business in a period of low interest rates, like we have currently, do you use a higher discount rate to factor in higher rates in the future? And also, when — do you ever look at a company's free cash flow yield relative to current rates?

WARREN BUFFETT: The question on discount rates, we use the same discount — I mean in theory — we would use the same discount rate across all securities, because if you really knew the cash they were going to produce, you know, that would take care of it. We may be more conservative in estimating the returns of cash from some, but the discount rate we would use is a constant.

Now, in terms of where we commit, you know, we don't want to use the fact that short-term rates are 1 1/4 percent to think that something that yields us 3 percent or 4 percent is a good deal. So we sort of have a minimum threshold in our mind about which we're — below which — we're unwilling to commit money. And we're unwilling to commit it whether interest rates are 6 or 7 percent, or whether they're 3 or 4 percent, or whether they're, on a short-term basis, 1 percent.

We just — we don't want to get hooked into long-term investments at low rates just because they're a little bit better than short rates would be or low Government rates would be. So, we have minimum thresholds in our mind. I can't tell you precisely what they are, but they're a whole lot higher than present Government rates would be. And at other times, we'd be very happy owning Governments, just because we feel that they offer attractive enough rates.

I would — when we're looking at a business, we're looking at holding it forever. And we want to be sure we're getting an adequate return on capital. We don't regard what we can get on short term rates now as adequate, but we'll still sit in — rather than bend a little bit and start settling for lower rates for 30 years because rates for 30 days are so low, we would rather just sit it out and wait a while.

36. Why Berkshire wants at least a 10 percent return

AUDIENCE MEMBER: Good afternoon. I'm Patrick Wolff from Arlington, Virginia. Charlie, I can't resist telling you that I'm actually the fellow who plays the chess games blindfolded. I actually have a two-part question. I'd like to ask you to elaborate a bit how you think about opportunity costs. And I'm — I think I'm going to be elaborating very much on the very last question that was asked.

First of all, in the annual report you say explicitly that you look for a 10 percent pretax return on equity, in looking at common stocks. And I think you talked earlier about how you built up from that for 5 to 6 percent after-tax return, and then you layer on inflation, and then layer on taxes. My first question would be, how do you adjust that required rate of return across periods of time? So, for example, when interest rates are higher. And do you look for a different equity premium return over different periods of time?

My second question would be, Warren, you just said that you actually would apply the same discount rate across the stocks. And I'm sure you know that modern finance actually suggests that you should not do that — that you should be thinking about the timing of cash flows and, in particular, the covariance with the general market.

Now, you've made a point of emphasizing that when you think of risk, you think of risk primarily in terms of, will you get the cash flows that you predict you will get over time? Sort of numerator risk, if you think in terms of discounted cash flow, which I think everyone here will have to acknowledge — your results speak for themselves — has probably been a very effective way of thinking about risk. But there is a true economic cost to think about the timing of cash flows as well. And it may be a much smaller cost, but it is still a real cost.

I might, for example, suggest you think about somebody deciding between two jobs. The jobs are completely identical and the person expects to make the same amount of money from each job, but there's one difference. And the difference is one job will pay him more when the economy's in the tank, and the other job will pay him more when the economy's going gangbusters.

Now, if he asked you which job was actually worth more, my guess is you would tell him that the one that would pay him more when the economy's in the tank. And the reason is, if he wanted to make more money by moonlighting or doing something else, it'd be much easier when the economy's doing better.

That's the essential logic behind the idea that you look at the covariance of when cash flows come in with the overall market. It's a real cost, even though it is difficult to measure, and even if it is a smaller risk than numerator risk, the risk of getting the actual cash flows, since it's a real cost, I imagine you must think about it. And so, my second question to you would be how do you think about it? And if you decide not to, why?

WARREN BUFFETT: The question on opportunity costs and the 10 percent we mention. You know, basically that's the figure we quit on. **And we quit on buying — we don't want to buy equities where our real expectancy is below 10 percent.**

Now, that's true whether short rates are 6 percent or whether short rates are 1 percent. We just feel that it would get very sloppy to start dipping below that. And we would add, we feel also, obviously, that we will get opportunities that are at least at that level, and perhaps substantially above. So, there's just a point at which we drop out of the game. And it's arbitrary. There's no — we have no scientific studies or anything.

But I will bet you that a lot of years in the future we, or you, will be able to find equities that you understand, or we understand, and that have the probability of returns at 10 percent or greater. Now, once you find a group of equities in that range, and leaving aside the problem of huge sums of money, which we have, then we just buy the most attractive. That usually means the ones we feel the surest about, I mean, as a practical matter.

There's just some businesses that possess economic characteristics that make their future prospects, far out, far more predictable than others. There's all kinds of businesses that you just can't remotely predict what they'll earn, and you just have to forget about them. But when we get — so, we have, over time, gotten very partial to the businesses where we think the predictability is high. But we still want a threshold return of 10 percent, which is not that great after-tax, anyway.

CHARLIE MUNGER: Yeah. **The — I think in the last analysis, everything we do comes back to opportunity cost. But it, to some extent — in fact, to some considerable extent — we are guessing at our future opportunity cost. Warren is basically saying that he's guessing that he'll have opportunities in due course to put out money at pretty attractive rates of return, and therefore, he's not going to waste a lot of firepower now at lower returns. But that's an opportunity cost calculation.**

And if interest rates were to more or less permanently settle at 1 percent or something like that, and Warren were to reappraise his notions of future opportunity cost, he would change the numbers. It's like [economist John Maynard] Keynes said, "What do you do when you change your view of the facts? Well, you change your conduct." But so far at least, we have hurdles in our mind which are basically — well, they involve, implicitly, future opportunity cost.

WARREN BUFFETT: Right now, with our 16 billion that's getting 1 1/4 percent pretax, that's $200 million a year. We could very easily buy Governments due in 20 years and get roughly 5 percent. So, we could change that 200 million a year to 800 million a year of income**. And we're making a decision, as Charlie says, that it's better to take 200 million for a while, on the theory that we'll find something that gives us 10 percent or better, than to commit to the 800 million a year and then find that, in a year or thereabouts, when the better opportunities came along, that what we had committed to had a big principal loss in it. But that's — you know that's not — it's not terribly scientific. But it — all I can tell you is, in practice, it seems to work pretty well.**

CHARLIE MUNGER: Years ago, when Warren ran a partnership, and to some extent the partnership that I ran was the — operated in the same way — we implicitly did what you're suggesting, in that part of the partnership funds were in so-called event arbitrage investments. And those tended to generate returns, occasionally, when the market, generally, was in the tank. And alternative investments would more mimic the general market. So, we were doing what this academic theory prescribes, you know, 40 years ago. And — but we didn't use the modern lingo.

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22. Asset allocation models are "pure nonsense"

I mean, 60/40 or 65/30 — it just doesn't make any sense. What you ought to do is have — your default position is always short-term instruments. And whenever you see anything intelligent to do, you should do it. And you shouldn't be trying to match up with some goal like that. But so much of what you see when you talk about asset allocation — it's just merchandising. It's a way to make you think that if you don't know how to determine whether it should be 60/40 or 65/35, that you need these people. And you don't need them at all in investing.

29. Method for estimating a company's future growth and establishing a margin of safety

AUDIENCE MEMBER: Good morning. I'm Marc Rabinov from Melbourne, Australia. Mr. Buffett and Mr. Munger, I'd like to ask you, when you assess a business and derive its intrinsic value, how do you estimate the future growth of the business, and how do you decide what margin of safety to use? Thank you.

WARREN BUFFETT: You calculate — I think you take all of the variables and calculate them reasonably conservatively. But you don't try and put too much windage in at every level. And then when you get all through, you apply the margin of safety. So I would say, don't focus too much on taking it on each variable in terms of the discount rate and the growth rate and so on. But try to be as realistic as you can on those numbers, but with any errors being on the conservative side. And then when you get all through, you apply the margin of safety.

But it's the same thing we do in insurance. I mean, if we're trying to figure out what we should charge for, we'll just say, the chances of a 6.0 earthquake in California, well, we know that in the last century, I think that there have been 26 or so 6.0 or greater quakes in California. And let's forget about whether they occur in remote areas, let's just say we were writing a policy that paid off on a 6.0 or greater quake in California, regardless of whether it occurred in a desert and did no damage or anything.

Well, we would look at the history and we'd say, "Well, there've been 26 in the last century." And we would probably assume a little higher number in the next century, that'd just be our nature. But we wouldn't assume 50. If we did, we wouldn't write any business. So we would — we might assume a little higher. I would, if I was pricing it myself, I'd probably say, "Well, I'll assume there are going to be 30, or maybe 32, or something like that."

Then when I get all through, I'll want to price the — I'll want to put a premium on it that now puts in a margin of safety. In other words, if I figured the proper rate for 32 is a million dollars, I would probably want to charge something more than a million dollars to build in that margin of safety. But I don't want to hit it at — I want to be conservative at all the levels and then I want to have that significant margin of safety at the end.

WARREN BUFFETT: It becomes more difficult if somebody said they really want protect against a 9.0 or something like that. You know, is it one in 300 years? Is it one in a thousand years? You know, when you get really off the data points. But that is not what you're looking at in investments. You don't want to look at the things that are that — you don't want to come up with the companies where you make the assumptions that get that extreme. And you don't have to, that's the beauty about investments. You only have to look at the ones that you feel capable of evaluating and you skip all rest.

Indexing

WARREN BUFFETT: Well, we never recommend buying or selling Berkshire. **But I would say that, among the various propositions offered you, a very low-cost index fund where you don't put all your money in at one time. I mean, if you accumulate a low-cost index fund over 10 years with fairly regular sums, I think you will probably do better than 90 percent of the people around you that take up investing at a similar time.**

Financial Risks

But I would say, if you talk about transforming events, or really talk about major events that could have huge consequences that are low probability, they're more likely to be in the financial arena than in the natural phenomena arena. But we'll think about them in both cases. But we do spend a lot of time thinking about things that can go wrong in a very big and very unexpected way. So we believe almost anything can happen in financial markets. And the only way smart people can get clobbered, really, is through leverage. If you can hold them, you have no real problems.

1. Difficulties of judging whether a company has ethics

AUDIENCE MEMBER: After reading this story on Enron, I would like to ask you the following question. How does an entry-level employee in a large company find out if her employer operates with a long-term perspective, and with honesty and integrity?

WARREN BUFFETT: Well, that's a very good question. I'm not sure I'm going to have an equally good answer. It — You know, you pick up signals — or frequently, you can pick up some signals — about what is going on at the top of a business if you're at a lower level. But I would say it would be very easy to be fooled on that subject. **Charlie and I would tend to be looking at things that they do in public in relation to their investors and the promises they make, and all of that sort of thing**. But I think that might be tough for people, and it wouldn't always give you a great guide.

I've — we've been suspicious of companies, for example, that place a whole lot of emphasis on the price of their stock. I mean, when we see the price of a stock posted in the lobby of the headquarters or something, you know, things like that make us nervous. But I'm not so sure that's, you know, that that would be enormously helpful.

So I guess you just have to sort of pick up from coworkers, publications, pronouncements of the leaders, the sort of culture that was being presented to them and the world, and, you know, you might get suspicious about it. But I don't think I have a really good answer for that, do you Charlie? CHARLIE MUNGER: No, it's obviously easy when you've got a caricature of a person like Bernie Ebbers or Kenny Lay. I think it's easy to say that you've got almost a psychopath — (laughter) — in charge.

13. "PetroChina was both cheaper and had less risk"

WARREN BUFFETT: Yeah, PetroChina itself is not a complicated or opaque company. You know, the country, you know, has obviously, different characteristics in many respects than the United States. But the company is very similar to big oil companies in the world. I — and I — PetroChina may have been the fourth largest — fourth most profitable — oil company in the world last year. I may be wrong on that.

But they produce 80 or 85 percent as much crude daily as Exxon does, as I remember. And it's a big, big company. And it's not complicated. I mean, you know, obviously, a company with half a million employees, and all of that. But a big integrated oil company, it's fairly easy to get your mind around the economic characteristics that will exist in the business.

And in terms of being opaque, actually their annual report may well tell you more about that business, you know, than you will find from reading the reports of other oil giants. And they do one thing that I particularly like, which other oil companies don't, at least to my knowledge, is that they tell you they will pay out X percent, I think it's 45 percent of their earnings, absent some change in policy.

But I like the idea of knowing in a big enterprise like that that 45 percent of what they earn is going to come to Berkshire, and the remainder will be plowed back. It was bought not because it was in China, **but it was bought simply because it was very, very cheap in relation to earnings, in relation to reserves, in relation to daily oil production, and relation to refining capacity. Whatever metric you wanted to use, it was far cheaper than Exxon, or BP, or Shell, or companies like that.**

Now, you can say it should be cheaper, because you don't what'll happen with it 90 percent owned by the government in China, and that's obviously a factor that what — you stick in valuation. But I did not think that was a factor that accounted for the huge differential in the price at which it could be bought. And, you know, so far it looks OK on that basis. We weren't — we aren't there because it's China, but we're not avoiding it because it's China, either. We just — we stick in a fairly appropriate number.

But if you read the annual report of PetroChina, I think that there's no — you will have as good an understanding of the company as you would if you read the annual report of any of the other big oil majors. And then you would factor in your own thinking about whether there could be some huge disruption in Chinese-American relationships or something of the sort, where you would lose for reasons other than what happened in terms of world oil prices, and that sort of thing. But we're happy with it.

WARREN BUFFETT: Yeah, you can — Yukos, as you know, is a very big Russian oil company. And in evaluating Russia versus China, in terms of country risk, you know, you can make your own judgments. But in our view, something like PetroChina was both cheaper and had less risk. But other people might see that differently.

27. Basic principles and "uncommon sense"

WARREN BUFFETT: I would say that, at least in my case, I haven't been continually learning, in terms of the basic principles. You always learn a little more about given techniques, or we learn — you know, I learn more about some industries over time, and therefore, maybe I've widened the universe in which I can operate, although more funds narrows it back down, unfortunately. But I know more about businesses than I knew 20 years ago, or 40 years ago. I haven't really changed the principles.

The last change — the basic principles are still Ben Graham. They were affected in a significant way by Charlie and Phil Fisher, in terms of looking at the better businesses. But they — but I didn't leave any of — I didn't leave Graham behind on that. And I really haven't learned any new fundamental principles. But I may have learned a little bit more about how business operates over time.

And there's really nothing — I mean, you ought to get an investment framework that comes straight from, in my view, from "The Intelligent Investor," and from Phil Fisher, more from "The Intelligent Investor," actually. And then I think you ought to learn everything you can about industries and businesses that — where you think you have the ability to get your mind around them if you work at them. And with that arsenal, you'll do very well, and if you've got the temperament for the business.

CHARLIE MUNGER: You have to have the temperament, and the right basic idea. And then you have to keep at it with a lot of curiosity for a long, long time.

WARREN BUFFETT: You know, it, I mean, it's a — when you get, you know, a company that is doing 2 1/2 million barrels a day, that's 3 1/2 percent of the — or 3 percent — of the world's oil production. You know, and they're selling based on U.S. prices using WTI — you know, as West Texas Intermediate — as a base price, and where they have a significant part of the marketing and refining in a country, the tax rate's 30 percent.

They say they're going to pay out 45 percent to you in dividends. Don't have unusual amounts of leverage. If you're buying something like that at well under half what — or maybe a third — of what comparable oil companies are selling for, that's not high-level stuff. I mean, you have to read some — you have to be willing to read the reports. But I enjoy doing that. But you wouldn't say that requires any high-level insights or anything, Charlie?

CHARLIE MUNGER: The insights can't have been all that common. No, I think that takes a certain amount of what an old Omaha friend used to call "uncommon sense." He used to say, "There is no common sense. When people say common sense, they mean uncommon sense." Part of it, I think, is being able to tune out folly as distinguished from recognizing wisdom. And if you just got whole categories of things you just bat away, so your brain isn't cluttered with them, then you're better able to pick up a few sensible things to do.

WARREN BUFFETT: Yeah, we don't consider many stupid things. You know, we get rid of them fast. And in fact, people get irritated with us, because they'll call us, and when they're in the middle of the first sentence, we'll just tell them "forget it." You know, and we don't — we can see it coming. And getting rid of the nonsense, I mean, just figuring that, you know, people start calling you and say, "I've got this great, wonderful idea." Don't spend 10 minutes, you know, once you know in the first sentence that it isn't a great, wonderful idea.

28. Estimating intrinsic value

AUDIENCE MEMBER: OK. We ended 2003 with about 5.422 billion of operating earnings. I estimated our look-through earnings to be approximately 915 million. So in total, that was about 6.337 billion of estimated look-through earnings. I knew that we spent a billion-two on CAPEX, and our net depreciation on tangible assets was 829 million. So, there was a difference there of 173 million. And we spent more on CAPEX over the appreciation, over the last few years. But in extrapolating out 20 years, I thought I might be kidding myself to ascertaining the differences between CAPEX and depreciation. And I'm using look-through earnings as a rough proxy for distributable earnings.

And I've assumed that Berkshire can grow its look-through earnings at 15 percent per annum, from years one to five, and at 10 percent per annum, from years six to 20. And the business will stop growing after year 20, resulting in a 7 percent coupon from year 21 onwards. I discounted the cumulative flows in years one to 20 by 7 percent, and I discounted the terminal value by 7 percent. I added the two together, to get what I thought was the intrinsic value of Berkshire's cash stream. I knocked off 103 billion of liabilities and minority interests. I divided by 1,537,000 shares, to arrive at what I thought was a conservative calculation of the range of Berkshire's intrinsic value. Am I off the mark, or is that the sort of methodology you might use yourself?

WARREN BUFFETT: Well — (Laughter and applause) — well, you've done your homework. (Laughter) The line of thinking is correct, it just depends on what variables you plug in. And we might have different ideas on variables, and neither one of us knows. But the approach, in general, the approach of trying to figure out distributable cash over a period of time. The business today is worth, the present value at some number — you're using 7 percent, but the question of what number to use —

But it's worth the present value of all the cash it can distribute between now and Judgment Day. And if cash can be retained, and it's at a rate higher — it produces — at a rate higher than your discount rate, obviously, you'll get some benefit from that retention. But, you know, I would say that your assumptions about CAPEX, and related to depreciation, I would expect CAPEX to be, on average, a little more than depreciation unless we run into highly inflationary times. But of course, we have to keep buying businesses, and using the capital in the business that we retain. If we retain those earnings, we have to use that to buy more businesses. And then the question is, what kind of returns can we expect on those?

I don't quarrel with the approach you're using, but, you know, everybody has to do their own equation and plug in some numbers. And I think we might settle for lower numbers on earnings gains than you postulated because we're very large, and it's — it gets harder all the time to deploy the kind of funds that keep flowing into Omaha.

30. Advice to young people: avoid credit card debt and hang out with people better than You

And I just think that, obviously, young people are more receptive to change, or to actually at even forming habits that are going to be useful in life. And I think that people underestimate — until they get older — they underestimate just how important habits are, and how difficult they are to change when you're 45 or 50, and how important it is that you form the right ones when you're young.

CHARLIE MUNGER: Well, all the trite stuff is what works. I mean, you avoid doing the really dumb things, like, racing moving trains to the crossing — (laughter) — experimenting with cocaine — (laughter) — risking getting AIDS or other unfortunate ailments. There are just a lot of standard things that take people down. And you just give those a wide berth. And then you want to develop a good character, and good mental habits, and you want to learn from your mistakes, every single one, as you go along. It's pretty obvious, isn't it?

WARREN BUFFETT: The expert. The — yeah, the — you know — It's better to hang out with people better than you. I found that very easy to do over the years. (Laughs) But if you're picking associates, pick out those whose behavior is somewhat better than yours, and you'll drift in that direction. And similarly if you hang out with a bad bunch, you're very likely to find your own behavior worse over time.

CHARLIE MUNGER: And my final word of advice would be, if this gives you a little temporary unpopularity in your peer group, the hell with them.

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Opportunities

There have been at least three times, maybe more, where it's looked to me in my own career, where it looked like there was so much money sloshing around that it would be impossible to do intelligent things with money. And I actually terminated a partnership back at the end of 1969 because I felt that that the money was coming out, you know, of the woodwork. There were all kinds of people that wanted to use it and compete, and I just didn't feel we could do intelligent things. Within four years, I saw the greatest opportunities that I've ever seen in my lifetime. And we've had several experiences like that.

Early Start

But the advice I would give is to read everything in sight. And to start very young. It's a huge advantage in almost any field to start young. If that's where your interest lies, and you start young, and you read a lot, you're going to you're going to do well. I mean there are no secrets in this business that only the priesthood knows. I mean, you know, we do not go into temples and look at tablets that are only available to those who have passed earlier tests or anything.

It's all out there in black and white. It's a simple business. It's not — it requires qualities of temperament way more than it requires qualities of intellect. But you do need a certain temperament that enables you to think for yourself. And then you have to develop a framework — and I developed it from reading Ben Graham, I didn't come up with it myself — very simple framework. And then you have to look for opportunities that fit within that framework as you go through life, and you can't do something every day. You know, you can learn every day, but you can't act every day.

PetroChina

Last year it earned $12 billion. Now, if you look at the Fortune 500 list, my guess is you won't find more than about five companies in the United States that earn $12 billion or more. So it's a major company. At the time we bought it, the total market value was 35 billion. So we bought it at about three times what it earned last year. It does not have unusual amounts of leverage. It — in the annual report, they say something which very, very few companies do say, but which I think is actually fairly important. They say they will pay out about 45 percent of the amount they earn.

So, if you can buy it at three-times earnings, what turned out to be three times earnings, and you get 45 percent of 33 percent, you know, you're getting a 15 percent yield on your — cash yield — on your investment. It was interesting. At the time — I think I'm right on this — at the time, Yukos, which is the big oil company in Russia, was probably far better known among the investment community in the United States than PetroChina. And I compared the two. At the time, thought to myself, would I rather have the money in Russia or in China? PetroChina, in my view, was far cheaper. And I felt that the economic climate was likely to be better in China, you know.

Would I have — if it had been selling at the same multiple as a U.S. domestic company, would I have regarded it as more attractive? No. I mean, there's some disadvantages, always, to being in a culture that you don't perfectly understand, or where tax laws can change, your ownership rules can change. But the discount at which PetroChina was selling, compared to other international oil companies, was, in my view at the time, ridiculous. So, that's why we bought it.

Business Success

So, I think it's tough. I think it's tough to go out to the practice tee, where people are not actually hitting balls but just taking practice swings, and say which one is, you know, is a 2 handicap and which one's a 15 handicap, and which ones, you know, can make it on the tour I think I can tell a little bit, maybe, but not — but it's very hard to calibrate. And I don't think we've had much success, but we also haven't tried very much, to identify people before they've had a record, to try and identify the ones that are superstars. Instead, we've taken the easy way, and we go — and if somebody comes to us with a business that's done phenomenally for 10 or 15 or 20 years, or maybe for 50 years, and we've seen how — what their batting average is — we've actually seen they batted .350, or whatever it may be, in the major leagues. And we just make the assumption that we won't screw it up by hiring them.

And we also make the assumption that they'll live to be 100 or 120 or something and we buy the business. And that's far easier — it is far easier to tell the great baseball batters after you've seen a couple seasons of their batting than it is to go to a college — in college baseball teams or high school baseball teams — and pick out the superstars.

The one interesting thing, and I wish I could remember where I saw this study and it may not even be a valid study, but I do remember seeing something many, many years ago where they tried to correlate business success with various variables. And they took grades in school and whether they got MBAs and all that sort of thing, and they found that the best correlation was with the age at which they started their own business first. The people that got very interested in starting a lemonade stands, or whatever, tended to have better — it tended to correlate better with business success than other variables.

Valuations

I mean, that you do see circumstances that are extreme enough that you can make a statement that is likely to look reasonably intelligent five or 10 years later. And I've seen a few of those times in my lifetime. I mean, I — and I've spoken out a couple of times. And I did in '69 and '74 and a few times. Most of the time, you know, you're in some in between zone.

Obviously, you get more for your money in equities now than you got, say, in the summer of 1999, which is when I delivered a talk out of Sun Valley that later got turned into an article for Fortune. But that was an — I spoke out then because it was extreme. I mean, I knew in a general way that I was going to be right, particularly in certain aspects of the market, but I didn't know when, and then I didn't know how right or anything of the sort. And you could've done the same thing in the other direction back in the mid-'70s.

I think that if you had to make a choice between owning long-term bonds, which are now yielding — the Treasury — only a little over 4 1/2 percent, or owning equities for the next 20 years, and you couldn't make — change that decision, I would certainly prefer equities. But I think people that have expectations that they can earn more than 6 or 7 percent in equities, and certainly when they start expecting double digits, I think the degree to what they have expectations, they can do that or that they can find somebody else to do it for them, I think they're making a big mistake.

But 6 or 7 percent is not the end of the world at all. In fact, it — and it gets treated better taxwise right now than it has almost any — well, really anytime in my lifetime. And actually, at the time that the NASDAQ about hit its high, REITs were quite cheap in my view. And I have less than 1 percent of my net worth outside of Berkshire, but basically I had that portion all in REITs. They were all small ones at that time.

CHARLIE MUNGER: And the REITs have phony accounting.

26. Avoiding emotional investment traps

So, my question is, is how do you — what are the mental tricks you have? Or how do you overcome these behavioral and emotional traps like anchoring? And what advice do you have for us?

WARREN BUFFETT: Well, that's a good question. And, of course, it first — the first step is in recognition of the fact that they can be traps and that you will be affected by them. And you will make some mistakes because of them. But Charlie in his — in "Poor Charlie's Almanack," which I probably do take credit for the name of, and the — he talks about the various psychological traps that people fall into. And simply reading that section, you will come away wiser than before you started on it.

We will — our personalities are such that Charlie and I probably are a little less prone to some of those mistakes than other people are. But as our record clearly indicates, we still are prone to them. And we make them and we'll make them again. We're probably a little less inclined to make some of them than we were 30 or 40 years ago. But, you know, the nice thing about it is, though, is that if you make fewer of those mistakes than others, you know, they will continue making their share and you'll get very rich.

CHARLIE MUNGER: Yeah. You don't have to have perfect wisdom to get very rich. All you've got to do is have slightly more than other people, on average, over a long time. (Applause)

WARREN BUFFETT: You know, it's the old story about the guy outrunning the bear. I mean, I don't have to outrun the bear. I just have to outrun that other fellow.

27. Low Treasury yields are a mystery

With signs of inflation, you know, in commodities and oil, why do you think the 10-year is still — you know, the yield is 4.2 percent? And, you know, is it that the market sees signs of deflation coming in the future? And in addition to that, if you thought rates would stay at this level for an extended period, would you have a more favorable view of the market?

WARREN BUFFETT: **Well, the answer to the second part is yes. I mean, if somebody guaranteed me that the 10-year rate would never go above 4.2 percent for the next 50 years, we would have to readjust, recalibrate every decision we make around Berkshire**. CHARLIE MUNGER: Yeah, I think the one thing you can confidently predict is there won't be some automatic and rational correlation between inflation and interest rates. There will be weird diversions.

2006

If we owned a copper mining company in its entirety, we would measure it, probably, more by cost of production than we would by whether copper was selling for $2.00 a pound or a dollar a pound. I mean, they — the management has control — depending on the kind of ore bodies and everything — but they certainly have control over operating conditions. They do not have control over market prices.

We do not want to pay for anything that is not under their control. We do not want to pay for the wrong things. And I would say, in a cyclical business, that you — you know, if oil is $70 a barrel, I don't think any particular management deserves credit for it. In fact, they all sort of deny that they've got anything to do with it when they get called before Congress. But I would not give them credit for the fact that oil is $70 a barrel or $40 a barrel. I would give them credit for low finding costs for — over time.

I mean, what you really want to do, **if you have a producing oil company, is you want a management that, over a five- or ten-year period, discovers and develops oil at lower-than average unit cost. There's been a huge difference in performance in that among even the major companies, and I would pay the people that did that well**. I would pay them very well, because they're creating wealth for me. And I would not pay the guy a lot of money that simply is cashing in on $70 oil and that really has got a terrible record in finding it at reasonable prices.

Home

We want what they see after they join us to underscore the values we have. So everything we do we hope is consistent with what most people would call a "culture" at Berkshire. So the written word, what they see, what they hear, what they observe. And that is training in itself. It's the same sort of training you get as a child. I mean, you — when you are in the home and you're learning something every day by the behavior of these terribly important people, these big people that are around you. And a home has a culture. A business has a culture. To some extent, a country can have a culture. And we try to do everything that's consistent with that. We try to do nothing that is inconsistent with that.

Technology Businesses

I mean, you get outside of — you just get into businesses that — where the future is so likely to be different than the present that maybe there's a few people that have great insights on it, but we sure don't. We are best at the businesses where we can come to a judgment that they're going to look a good bit like they do now five years from now, ten years from now. They'll be bigger. They'll be doing different things, but the fundamentals will be the same. ISCAR will be a bigger company five years from now. It may be a much bigger company, and we may get a chance to do interesting acquisitions.

But what you saw there, the fundamentals, won't change. The way the people think won't change. I can name a number of businesses that are bound to change dramatically. I mean, when you think of how much the telecom business, for example, has changed over the last 15 or 20 years, it's startling. Even with hindsight, it's a little hard to figure out, you know, who was going to make all the money and so on. There's just — there's just games that are too tough.

Commodity Speculation

Oil, if you go back a few years to when it was $10 a barrel — it's been more extreme than copper — but you were undoubtedly — it's like most trends. At the beginning, it's driven by fundamentals, and at some point, speculation takes over. The very fact that — the fundamentals cause something that people looked at for years without getting excited about. Fundamentals change the picture in some way. Copper does get a little short, you know, or people get a little worried about currency and, maybe, gold goes up or whatever it may be.

But, you know, it's that old story of what the wise man does in the beginning, the fool does in the end. And with any asset class that has a big move, that's based initially on fundamentals, is going to attract speculative participation at some point, and that speculative participation can become dominant as time goes by.

And, you know, famous case always being tulip bulbs. I mean, tulips may have been more attractive than dandelions or something, so people paid a little more money for them. But once a price history develops that causes people to start looking at an asset that they never looked at before and to get envious of the fact that their neighbor made a lot of money without any apparent effort because he saw this early and so on, that takes over. And my guess is that we're seeing some of that in the commodity area. And, of course, I think we've seen some of it in the housing area, too.

How far it goes, you never know. I mean, it just — some things go on to just unbelievable heights, and then, you know, silver went back and that was manipulation, to some extent, but it got up to $50 an ounce very briefly back in the early '80s. And my guess is that an awful lot of the activity in something like copper now is speculative on both sides of the market. If — you know, if it goes to $5 a pound, who knows? But it — you are looking at a market that is responding more to speculative forces now than to fundamental forces, in my view.

Internet Impact on Media and TV

The outlook, I mean, compared to — like I say, they're enormously profitable now, in returns on tangible assets. I mean, it's a business — you know, a license from the federal government became a royalty stream on huge amounts of money.

I mean, there were only three highways between — electronic highways — between Procter & Gamble and Ford Motor and the eyeballs of several hundred million people, and those three highways could make a lot of money when there were only three highways. But you keep building more ways to — for the P&Gs, or the Gillettes, or whomever it might be, or Ford Motor, or General Motors — to get to those eyeballs, and you decrease the value of the highways. It's not complicated.

So, I think you will see — it's hard to imagine those businesses having great prospects in aggregate. We owned the World Book. We still own the World Book. We were selling 300,000 sets a year or something like that in the mid '80s. It's a very valuable product. It sold for $600 or thereabouts, and it was worth it.

But the problem became that you could get that same information, or a good bit of the same information, you know, very, very cheap through the internet. And you didn't have to cut down trees. And you didn't have to run paper mills. And you didn't have to hire United Parcel Service to deliver a very bulky package. And it isn't that the product we have isn't worth the money; it's that people have lots of other alternatives. And that's true in information and entertainment in a big, big way, and it won't stop, in my view.

Studying Business from Others

And I'm wondering if you could provide us with a few names of some present-day mentors that we may look to for advice and our own ways to approach problems and situations, people similar to the Grahams and the Fishers of the present day?

WARREN BUFFETT: Well, the interesting thing, you don't have to look at the present-day ones, necessarily. I mean, if you wanted to look at great business careers, you could look at Tom Murphy or Don Keough on our board. And you can learn everything you could learn about being an outstanding businessperson by just studying them. And you don't have to study somebody that is 55 and currently in some executive position. Their lessons are timeless. And there's going to be a study — I think the Harvard Business — somebody sent it to me from the Harvard Business School, you know, on Cap Cities.

But there's been others in the past. And, you know, if you learn the lessons of Tom Murphy, you don't need to learn any other lessons in terms of business. And I would say if you learn the lessons of certain investors in the past, you know, you don't need to worry about a contemporary example.

13. If we were starting out again

My question is this: if you were starting out today with a million dollars, with a vision of building a business with 20 percent average growth in value over 40 years, what type of investments and investment strategy would you look to make in the first five years?

WARREN BUFFETT: Well, it's somewhat interesting that we formed the first partnership 50 years ago last — 2 days ago, Thursday, May 4, 1956, which was 105,000. (Applause) That's my sister clapping. She was in the partnership. (Laughter) The — we would — if Charlie and I were starting all over again and we were in this, Charlie would say we shouldn't be doing this. (Laughter)

But if we were to succumb to Satan and engage in the same kind of activity, we would, I think, be doing something very similarly. If we were investing in securities, we would look around the world, and we would look at a Korea. And Charlie says you can't find 20 of them, but you don't have to find 20 of them; you only have to find one, really. You do not have to have tons of good ideas in this business, you just have a good idea that's worth a ton, occasionally.

And in securities, we would be doing the same thing, which would probably mean smaller stocks — it would mean smaller stocks — because we would find things that could have an impact on a small portfolio that will have no impact on a portfolio the size of Berkshire. If we were trying to buy businesses, we'd have a tough time. We would have no reputation, so people would not be coming to us. We'd be too small a player, if you're talking about a million dollars. So we would not have much success, I don't think, with small amounts, buying businesses.

Charlie started out, you know, in real estate development because it took very, very little capital, and you could magnify brain power and energy — or, I should say, brain power and energy could magnify small amounts of capital in a huge way that was not true in securities. You know, my natural inclination was to look at securities and just kind of do it one foot in front of the other over time. But the basic principles wouldn't be different.

You know, I think if I'd been running a partnership a couple of years ago with a small amount of money, I think I'd have probably been 100 percent in Korea. And, you know, I would be looking around for something that was very mispriced and which — and that I understood. And every now and then, that's going to happen.

CHARLIE MUNGER: Well, I agree with that. The concept that you're likely to find just one thing where it will make 20 percent per annum and you just sit back for the next 40 years, that tends to be dreamland.

And in the real world, you have to find something that you can understand that's the best you have available. And once you've found the best thing, then you measure everything against that because it's your opportunity cost. That's the way small sums of money should be invested. And the trick, of course, is getting enough expertise that your opportunity cost — meaning your default option, which is still pretty good — is very high.

CHARLIE MUNGER: Yeah. When Warren said he would have been all in one country, that's pretty close to right. He wouldn't have quite done that when he had the partnership, but he would have been way more concentrated than is conventional if you listen to modern portfolio theory. Most people aren't going to find thousands of things that are equally good; they're going to find a few things where one or two of them are way better than anything else they know. And the right way to think about investing is to act thinking about your best opportunity cost.

Independent Thinking

WARREN BUFFETT: Yeah. Well, Ben Graham said long ago that you're neither right nor wrong because people agree with you or disagree with you. In other words, being contrarian has no special virtue over being a trend follower. You're right because your facts and reasoning are right. So all you do is you try to make sure that the facts you have are correct. And that's usually pretty easy to do in this country. I mean, information is available on all kinds of things. Internet makes it even easier.

And then once you have the facts, you've got to think through what they mean. And you don't take a public opinion survey. You don't pay attention to things that are unimportant. I mean, what you're looking for is something — things that are important and knowable. If something's important but unknowable, forget it. I mean, it may be important, you know, whether somebody's going to drop a nuclear weapon tomorrow but it's unknowable. It may be all kinds of things. So you — and there are all kinds of things are that knowable but are unimportant.

In focusing on business and investment decisions, you try to think — you narrow it down to the things that are knowable and important, and then you decide whether you have information of sufficient value that — you know, compared to price and all that — that will cause you to act.

Shorting

I would say that it's a very, very tough way to make a living. It's not only often painful financially, it's very painful emotionally because it — a stock that you sell short — a stock that you buy at 20 can go down 20 points, and a stock that you sell short at 20 can go up an infinite amount. And you don't think about that until you've gone short and it goes up 10 or 15 points, and then you don't sleep very well. So it's a very tough way to make a living. Short sellers — the situations in which there have been huge short interests very often — very often have been later revealed to be frauds or semi-frauds. Now, the one my friend runs is not at all.

But the — the batting average — I mean, I've — over the years, I've probably had a hundred ideas of things that should be shorted, and I would say that almost every one of them have turned out to be correct. And I'll bet if I'd tried to do it and make money out of it, I probably would have lost money, I would have had no fun, and the opportunity cost, as Charlie said, would have been enormous. Because if somebody's running something that's

semi-fraudulent, they're probably pretty good at it and they're working full time at it and they've succeeded for a while and they may keep succeeding.

And if they succeed and you go in at X and it goes to 5X, you know, all you're hoping after a while it that it goes back to X again or something of the sort. It's a very tough psychological game to play. Few people may be well-suited for it. I would never put any money with a short fund, but not because I would think it would be ethically wrong. I just think they're unlikely to make money.

CHARLIE MUNGER: **Well, I think you're absolutely right there — in the sense that it's — that would be one of the most irritating experiences in the world, to figure out something is crooked and foolish and so forth and then short it at X and have it go to 3X. Now you're watching all these happy crooks splashing around in your money while you're meeting margin calls. Why would you want to go in hailing distance of an experience like that?**

2007

7. What an annual report tells you about the CEO

But in terms of marketable securities, we read the reports. Now, Charlie and I were just talking about one the other day where we read an annual report of a large oil company. And the company — you know, hundred pages, public relations people, lots of pictures — spent a fortune on it. **And you can't find in that report what their finding cost per McF or per barrel of oil was last year. That's the most important figure in an oil and gas company over a period of years, but every year counts. The fact it wouldn't even be discussed — the reason it wasn't discussed, it was absolutely terrible — but the fact it wouldn't even be discussed — and to the extent it was touched on, it was done in a dishonest manner**. When we read things where we basically are getting dishonest messages from the management, it makes a difference to us.

You know, like I say, in marketable securities we can solve that by selling the stock, and it's not the same thing as buying the entire business. But I think you can learn a lot by reading the annual letters. I mean, for one thing, if it's clearly the product of some investor relations department or outside consultant or something of the sort, you know, that tells you something about the individual. If he's not willing to talk once a year through a few pages to the people that gave him their money to invest, I mean, that — I've really got — I've got some questions about people like that.

So I like that feeling that I'm hearing directly from somebody who regards me as a partner. And you may not get it all the way, but when I get it 0 percent of the way, I don't like it. I've still bought — we've still bought into some — in marketable securities — we've bought into some extremely good businesses where we thought they were run by people we didn't really like very well, because we didn't feel they could screw them up.

12. Pay attention to opportunity costs

Well, if government bond rates were 2 percent, we're not going to buy a business to earn 3 or 3 1/2 percent expectancy over the years. We just don't want to commit our money that way. We'd rather sit around and wait a little while. If they're 4 3/4 percent, you know, what do we hope to get over time? Well, we want to get a fair amount more than that. You know, it's a little bit of the — we want enough so that we feel very comfortable if they closed down on the stock market for a couple of years, if interest rates go up another hundred basis points or 200 basis points, we're still happy with what we've bought. And above that, I really — I know it sounds kind of fuzzy, but it is fuzzy.

CHARLIE MUNGER: Yeah. The concept of a hurdle rate makes nothing but sense, and yet a lot of terrible errors are made by people who are talking about hurdle rates. Just because you can measure something and guess it, doesn't mean that it's the controlling variable in what you're dealing with in a messy world.

And the trouble with the hurdle rate concept — not that we don't have one, in a sense — is it doesn't work as well as a system of comparing things. In other words, if I have something available that I think will give me 8 percent for sure and I can buy all I want of it, and you've got a perfectly good investment that I think will earn 7, I don't have to waste 5 minutes with you. You're like the mail order service offering the bride through the mail and she's got AIDS. You know, I can go on to some different subject. But in the real world, your opportunity costs are what you want to make your decisions based on.

WARREN BUFFETT: Yeah. And even if you had something you were really familiar with and were very sure on the 8 percent, 8 1/2 wouldn't tempt you if somebody came along, as a practical matter.

14. We're thinking all the time

My question to Mr. Buffett and Mr. Munger is, how often do you review each single position in your portfolio? Some look at their stocks every day, sometimes more, some only once a year. What is your frequency? Thank you.

WARREN BUFFETT: Well, that sort of breaks down into two periods in my life. When I had more ideas than money, I was thinking about everyone all the time because I was thinking about buying the next one and which one I would have to sell in order to buy something even more attractive. So my opportunity cost, as Charlie would put it, then, was the least attractive stock which I would give up to buy something more attractive.

So I — literally, if I had $100,000 and it was all invested and I wanted to put $10,000 or 20,000 into something I felt was more attractive, I would be thinking all the time of which one of these do I unload. Now our situation is such that we have more money than ideas, and that means that we really aren't re-examining something every minute, because the option is cash and not doing something that we really are excited about.

We still think about the businesses we're in — whether they're wholly owned or whether they're partially owned through stocks — we think about them all the time. I mean, we've got a lot of information filed away in our minds. And you keep getting little incremental bits about that company or the competition or other things going on. So it's — you know, it is a continuous process, but it's not a continuous process with the idea that daily activity, or weekly activity, or monthly activity, is going to result. It's just we want to just keep adding to our thinking and knowledge, refining it further about every business that we're in.

If we needed some money for a very big deal, for example — let's say we needed 20 or 30 or $40 billion and we had to decide to sell 10 billion of equities, just to pick a figure, you know, we would use the information we've been collecting daily, which hasn't really meant much as we've gone along, and we would come to a decision about where we raise that $10 billion.

CHARLIE MUNGER: Yeah. But even in Warren's salad days when he had way more ideas than he had money, he did not spend a lot of time thinking about his number one choice. You know, he could put that aside and devote his efforts to other subjects.

Start a business when young

But it is interesting — I read a study a long time ago — I wish I could get my hands on it because I've quoted it a lot but I never quoted it as authoritatively as I would be able to if I could actually find the damn thing that I read 30 years ago. But it correlated business success with certain variables. And, you know, they tried grades in school, and they tried what your parents did, and they tried whether you went to business school, all those kind of things.

And they found it correlated best with the age at which you started your first business, got into business, that the younger you were when you did your first piece of business seemed to correlate best with later business success. And to some extent, that's sort of natural. It's probably true that — that when you see it in athletics, you see it in music and that sort of thing. So whatever you can figure out that other people will pay you to do that they don't want to do themselves or that they'd like done for them — I advise you to look around the neighborhood and talk to your parents, talk to your friends, see what other people have done that have been 10 or 11 or 12 years old that's worked for them and copy it.

2008

15. How Buffett overcame his fear of public speaking

I was absolutely, throughout high school and college, terrified of public speaking. And I would have — I avoided any classes, signing up for them, that would require it. I would get physically ill if I even thought about having to do it, let alone doing it. And I took a Dale — well, I've — first of all, I signed up — I went down to a **Dale Carnegie course** when I was at Columbia, and signed up for it, gave him a check for a hundred dollars, went back to my room and stopped payment on the check. And then I came out to Omaha, and I saw a similar ad. It was at the Rome Hotel, for you oldtimers in Omaha, on 16th Street.

And I went down there, and this time I took a hundred dollars in cash and gave it to Wally Keenan, who some of you may know. He died some years ago. First time I'd met him. **And I took that course, and when I finished that course, I went right out to the University of Omaha and volunteered to start teaching, knowing that I had to get up in front of people. I think the ability to communicate, both in writing and orally, is of enormous importance, under taught. Most graduate business schools, they wouldn't find an instructor to do it because it would sort of be beneath them to do something so supposedly simple.**

But if you can communicate well, you have an enormous advantage. And to you, who are talking to the group of introverted people — and, believe me, I was in certain ways quite introverted — it — you know, it's important to get out there and do it while you're young. If you wait until you're 50 it's probably too late. But if you do it while you're young, just force yourself into situations where you have to develop those abilities. And I think the best way to do that is to get in with a whole bunch of other people who are having equal problems, because then you find you're not alone, and you don't feel quite as silly. And, of course, that's what they did at the Dale Carnegie course. I mean, we would get up in front of 30 other people who could hardly give their own name, and after a while we'd find that we could actually pronounce our own name in front of a group. But we would stand on tables and do all kinds of silly things, just to get outside of ourselves.

17. Long-short strategy wasn't a big money maker

"We buy something at 12 times earnings when comparables or poor-quality companies sell at 20 times earnings, but then a major revaluation takes place so that the latter only sell at ten times." Is this technique pair trading and, if so, how did you think about and calculate the ratio of longs to shorts?

WARREN BUFFETT: Yeah. I didn't remember we started as early as '64, but certainly in the '60s we did some of what, in a very general way, would be called pair trading now, which is a technique that's used by a number of hedge funds, and perhaps others, that go long one security and short another, and often they try to keep them in the same industry or something. They say that British Petroleum is relatively attractive compared to Chevron or vice versa, so they long one and short the other. And actually that technique was employed first by Ben Graham in the mid-1920s when he had a hedge fund, oftentimes — I read articles all the time that credit A.W. Jones with originating the hedge fund concept in the late '40s, but Ben Graham had one in the mid-1920s — and he actually engaged in pairs trading.

And he found out it worked modestly — very modestly — well because he was right about four times out of five but the time he was wrong tended to kill him on the other four. And then we went long things that we thought were attractive. **We did not go short things that we thought were unattractive; we just shorted out the market generally. And, generally speaking, I think if you've got some very good ideas on businesses that are undervalued, it's really unnecessary to do any shorting out of the market.** There's a — for those of you who are in the field — I mean, there's a — kind of a popular proposal — **money managers always have some popular proposal that's being sold to the potential investors — and now there's something called 130-30**, where you're long 130 percent long, short 30 percent. **That stuff is all basically a bunch of stuff just to try and sell you the idea of the day. It doesn't really have any great statistical merit.**

Cannot separate the business from financial statements

I wanted to know, if you could not talk with management, could not read an annual report, and did not know the stock price of a company, but were only allowed to look at the financial statements of a company, what metric would you look at to help you determine whether you should buy the company?

WARREN BUFFETT: **In the case you lay out, the first question you'd have to make is do I understand enough about this business so that the financial statements will tell me the information that's useful to me in making a judgment about what the future financial statements are going to look like. And in many cases, the answer would be no. Probably in a great majority of the cases it would be no. But I've actually bought stocks the way you're describing many times, and they were in businesses that I thought I understood where, if I knew enough about the financial past, it would tell me enough about the financial future that I could buy.**

Now, I couldn't say the stock was worth X or 105 percent of X or 95 percent of X, but if I could buy it at 40 percent of X, I would feel that I had this margin of safety that Graham would talk about, and I could make a decision. Most times I wouldn't be able to make it. I wouldn't know — if you hand me a bunch of financial statements and you don't tell me what the business is, there's no way I could make a judgment as to what's going to happen. It could have been a hula hoop business; it could have been a pet rock business. You know, on the other hand it could have been Microsoft early on. So unless I know the nature of the business, the financial statements aren't going to tell me much, you know. If I know the nature of the business and I see the financial statements, you know, if I see the financial statements on Wrigley, I know something about the business. Now I have to know something about the product before I can make that judgment.

But we've bought lots and lots of securities. The majority of the securities Charlie and I bought, we've never met the management and never talked to them, but we have primarily worked off financial statements, our general understanding of business, and some specific understanding of the industry in the business we're buying.

23. Buffett's advice to a 12-year-old

I just wanted to ask, what kind of things should I be reading, like, in my grade? 'Cause I know there are a lot of things that they don't teach you in school that you should know, but what things should I be looking into? (Applause.)

WARREN BUFFETT: Well, I would get in the habit, if you don't have it already — but you sound like you very well may — of reading a daily newspaper, which is not the most popular thing in the world among younger people these days. But you want to learn as much as you can about the world around you. And Bill Gates, I think, quit at the letter P in the World Book. Doesn't seem to have hurt him too much to quit there. But you can have a set of World Books. You can read the newspapers. You should just sop it up. And you'll find out what's the most interesting to you.

I mean, you know, there's a certain point where the sports pages were most interesting to me, then the finance pages. I happen to be a political junkie. But you just can't learn enough in life. And I think the fact — what you'll find is the more you learn, the more you want to learn. I mean, it is fun, and — but you sound to me like a young person that's going to do a lot of that on their own.

CHARLIE MUNGER: My suggestion would be that the young person that just spoke has already figured out how to succeed in life. You've got it made.

Buying Businesses

And then occasionally we get the chance to buy an entire business. We never do that at a bargain price. It just doesn't happen. People don't do that. The stock market gives you bargain prices; individual owners won't. But when we get a chance to do that at a fair price, we like doing it.

26. Small stocks and mispriced bonds offer opportunities

WARREN BUFFETT: Well, if I work with small sums of money — and I'd be happy doing that — it would just open up thousands of possibilities to me. So it could be in stocks. It could be in bonds. It wouldn't be in currencies with small amounts. But, you know, I had a friend who used to buy tax liens — you know, Tom Knapp, he's got some relatives here. An enterprising person can find a lot of different ways to make money. You'll find most of them will be in small stocks. If you're working with small money, they'll be in small stocks or in some specialized bond situations.

29. "Diversification is for the know-nothing investor"

I've read that there were several times in your investing career when you were confident enough in one idea to put a lot of your money into it — say, 25 percent or more. I believe a couple of those cases were American Express and the Washington Post in the '70s. And I've heard you discuss your thinking on those. But could you talk about any of the other times you've been confident enough to make such a big investment and what your thinking was in those cases?

WARREN BUFFETT: Charlie and I have been confident enough — if we were only running our own net worth — I'm certain a very significant number of times, if you go over 50 years, there have been a lot of times when you would have put at least 75 percent of your net worth into an idea. Wouldn't there, Charlie?

CHARLIE MUNGER: Well, but 75 percent of your worth outside Berkshire has never been a very significant amount.

WARREN BUFFETT: No. Well, I'm going back — let's just assume it was. (Laughter) Let's just assume you didn't have Berkshire in the picture. There have been times — I mean, we've seen all kinds of ideas we would have put 75 percent of our net worth in.

CHARLIE MUNGER: Warren, there have been times in my life when I've had more than a hundred percent of my net worth invested in things.

WARREN BUFFETT: That's because you had a friendly banker; I didn't. (Laughter) **That — there have been times — well, initially, I had 70 — several times I had 75 percent of my net worth in one situation. There are situations you will see over a long period of time. I mean, you will see things that it would be a mistake — if you're working with smaller sums — it would be a mistake not to have half your net worth in. I mean, there — you really do, sometimes in securities, see things that are lead-pipe cinches.** And you're not going to see them often and they're not going to be talking about them on television or anything of the sort, but there will be some extraordinary things happen in a lifetime where you can put 75 percent of your net worth or something like that in a given situation.

The problem has been the guys that have put 500 percent of their net worth in. You know, I mean, if you look at — just take LTCM. Very smart guys. Very decent guys. Some friends of mine. High grade. Knew their business. But they put, you know, maybe 25 times their net worth into things that were a cinch, if they hadn't have gone in that heavily. I mean, they were in things that had to converge, but they didn't get to play out the hand.

But if they'd have had a hundred percent of their net worth in them, it would have worked out fine. If they would have had 200 percent of their net worth in it, it would have worked out fine. But they instead went to, you know, maybe 2500 percent or something like that. So there are stocks — I mean, actually, there's quite a few people in this room that have close to a hundred percent of their net worth in Berkshire, and some of them have had it for 40 or more years.

Berkshire was not in a cinch category. It was in the strong probability category, I think. But I saw things in 2002 in the junk bond field. I saw things in the equity markets. If you could have bought Cap Cities with Tom Murphy running it in the early — in 1974, it was selling at a third or a fourth what the properties were worth and you had the best manager in the world running the place and you had a business that was pretty damn good even if the manager wasn't. You could have put a hundred percent of your net worth in there and not worry. You could put a hundred percent of your net worth in Coca-Cola, earlier than when we bought it, but certainly around the time we bought it, and that would not have been a dangerous position. It would be far more dangerous to do a whole bunch of other things that brokers were recommending to people.

WARREN BUFFETT: And there's nothing wrong with the know-nothing investor practicing it. It's exactly what they should practice. It's exactly what a good professional investor should not practice. But that's — you know, there's no contradiction in that. It — a know-nothing investor will get decent results as long as they know they're a knownothing investor, diversify as to time they purchase their equities, and as to the equities they purchase. That's crazy for somebody that really knows what they're doing. And you will find opportunities that, if you put 20 percent of your net worth in it, you'll have wasted the opportunity of a lifetime, you know, in terms of not really loading up. And we've had the chance to do that, way, way in our past, when we were working with small sums of money. We'll never get a chance to do that working with the kinds of money that Berkshire does. We try to load up on things. And there will be markets when we get a chance to from time to time, but very seldom do we get to buy as much of any good idea as we would like to.

3. Why we don't do 'due diligence' for even the biggest deals

Mr. Buffett, I was reading recently in Fortune magazine that when you invested $500 million in PetroChina back in 2001 or 2002, all you did was read the annual report. Now, I was thinking that most professional investors with the kind of resources that you have would have liked to have done a lot more research and talked to management, maybe regulators, et cetera, et cetera. The question I have is, how — what is it that you look for when you're reading an annual report like that? How is it that you were able to, and did, make an investment purely on the back of reading that report?

WARREN BUFFETT: Yeah. **Well, it was in 2002 and 2003, and the report came out in the spring, and I read it. And that's the only thing I ever did. I never contacted any management. I never got a brokerage report. I never asked for anybody's opinion. But what I did do is I came to the conclusion that the company — and it's not hard to understand crude oil production and refining and marketing and the chemical operation they have. I mean, you can do the same thing with Exxon or BP or any of them, and I do that with all — I look at them. And I came to the conclusion it was worth a hundred billion, and then I checked the price and it was selling for 35 billion, roughly.**

What's the sense of talking to management? I mean, basically, if you talk to management of almost every company, they'll say they think their stock is a wonderful buy, and they'll give you all the good stuff and skip over things that — it just doesn't make any difference. Now, if I thought the company was worth 40 billion and had been selling for 35 billion, then at that point you have to start trying to refine your analysis more. But there's no reason to refine your analysis. I mean, I didn't need to know whether it was worth 97 billion or 103 billion if I was buying it at 35 billion. So any further refining of analysis would be a waste of time when what I should be doing is buying the stock.

So we really like things that you don't have to carry out to three decimal places, you know. If you have to carry it out to three decimal places, it's not a good idea. And, you know, it — with something like PetroChina — it's like if somebody walked in the door here and they weighed somewhere between 300 and 350 pounds. I might not know how much they weigh, but I would know they were fat. (Laughter) That's all I'm looking for, is something that's financially fat. And whether PetroChina weighed 95 billion dollars or 105 billion didn't make much difference. It was selling for 35 billion. If it had been selling for 90, it would have made a difference.

So if you can't make a decision on something like PetroChina off the figures, forget about going further, and that's basically what we did. It's a straightforward report, just like reading another — just like reading Chevron's or ConocoPhillips or something like that. Just as informative. **And you weren't going to learn more, you know, by going out and deciding whether you thought — they've got one huge field in China where the life of it was 13 years or 14 years or something of the sort. They should hit you between the eyes.**

How to influence the CEO and Board of Directors

And I'm curious. As a common, ordinary person and a common shareholder, what can we do, 31,000-some odd folks here do, about the outrageous salaries, bonuses, perks, of these enormous corporations that we will never have a chance at, a shot at, you know, working with them and that amount of wealth? What would you advise us as common shareholders that we can do to get this country going the right way and get this issue going the right way?

WARREN BUFFETT: **Well, I would say that, particularly on the compensation part, you can't do much. But there are a relatively few people that could do a lot. If the half a dozen or so largest institutional owners took a position on extreme cases — I don't advise them trying to go after each one — but when they see something egregious, if they would simply withhold their votes and issue a short statement as to why they're doing it, that has an effect on — particularly on boards of directors. Big shots don't like to be embarrassed. You know, they don't — that gets their attention. The press is an enormous factor. Press is more of a factor in changing corporate behavior than regulations or Sarbanes-Oxley or that sort of thing.**

You want a good press. But the press needs the material, and material — the raw material — for that could be — I won't name the organizations — but if you take the half a dozen largest investment organizations, I think it would have a lot of impact if they would — if they could get together on short statements when they felt pay was really egregious. **I don't think — I think the — a lot of the checklists that institutions use as determining whether they approve of corporate practices are asinine. I mean, they — you know, they get sort of the "issue du jure" and they get — and they get people recommending how they vote their proxies, which is kind of silly. I don't know why they can't make up their minds themselves as to what they think is proper or not proper.**

And Ben Graham, many years ago, bemoaned investors as a bunch of sheep. And with big institutions, I haven't seen much difference. But it wouldn't take many of them. It would take — just take a few of the biggest ones and the willingness to speak out. And the press would do the rest and boards would respond to that. But they're not going to respond to you. I mean, I have to be, you know, totally candid about that.

A small shareholder can write the most persuasive arguments in the world, and I've been on the board where they've received those kind of letters. And basically they turn them over to the corporate secretary and say, "Take care of this," or something of the sort. It takes real effective pressure to change behavior where the behavior is in the self-interest of that person. People do not give up self-interest easily.

2009

CHARLIE MUNGER: Yeah, generally, I think it's quite smart to do what you're talking about — is to identify some investors you regard as very skilled, and carefully examine everything they're buying, and copy what you please. I think you have a very good idea.

2010

Chapter 12 of Keynes's "General Theory" is, by far, in my view, probably Charlie's too, the best description of the way capital markets function, the real way people operate. It's prescriptive, it's descriptive. Everybody should read chapter 12. It's a little — it starts a little slow in the first few pages.

Kraft

"What did you think of Kraft CEO Irene Rosenfeld's $26.3 million compensation package for services, including her leadership in completing the Cadbury acquisition and selling Kraft's North American frozen pizza business?"

WARREN BUFFETT: Well, I didn't like either the Cadbury decision or the pizza decision. But we've made our share of dumb deals at Berkshire, you know. So I've gotten more tolerant of other people, and incidentally the fact I think it's a dumb deal doesn't for certain make it a dumb deal, but I think the odds are it was a dumb deal. In fact, I think the odds are that both deals were dumb. The pizza deal was particularly dumb, but — in my view.

You know, the pizza business — somewhere I probably have some figures on that — but when they sold the pizza business for $3.7 billion they announced it as selling it for $3.7 billion. They didn't sell it for $3.7 billion, that's what the other guy paid. What they got was about $2.5 billion. And that was a terribly tax-inefficient deal when they'd already shown their ability to understand that you could do a tax-efficient deal when they sold the Post cereals business earlier. And when they referenced — well, they didn't reference at all what pizza was earning beforehand, but I think that Nestle said it was earning something like 280 million pre-tax, but that was referring to the previous year.

When they talked about the Cadbury earnings they were buying, they were talking about next year. And when they talked about the pizza earnings they were selling, they talked about last year. Pizza in 2009, believe it or not, earned three hundred and, I think, 40 million pre-tax. So they got 2 1/2 billion for 340 million of pizza earnings that were growing as fast or faster than the Cadbury earnings and where the sales were going as fast or faster. It really didn't make sense in my view.

Low Rates

WARREN BUFFETT: The pressure that is exerted by extremely low interest rates — short-term rates — on the value of everything else, it's hard to overestimate that. I mean, the reason people have their money out at one-tenth of 1 percent is that they're afraid of everything else. But as they're being afraid of everything else abates, as it has over the last couple years, the pressure to push stock prices up, push real estate prices back up, it's enormous.

And of course, that's understood by people who have something to do with those matters. But I don't think you should underestimate the degree to which the last year of stock prices has been a result of the agony that people are being put through that keep their money in short-term money instruments. Unless they're terrified of the world, they get pushed into other investments, and I think we've seen a lot of that, and we'll see what happens when money rates do go up, if they do.

Learning to Invest

CHARLIE MUNGER: Well obviously, if you want to get good at something which is competitive, you have to think about it a lot, and learn a lot, and practice doing it a lot. And the way the world is constructed in this field, you have to keep learning, because the world keeps changing and your competitors keep learning. So you just have to get up each morning and try and go to bed that night a little wiser than you were when you got up.

And if you keep doing that for a long time — and accumulate some experience, good and bad, as you try and master what you're trying to do — people who do that almost never fail utterly. They may have a bad period when luck goes against them or something. But very few people have ever failed with that. If you have the right temperament, you may rise slowly but you're sure to rise.

Fundamental algorithm of life

So I'd say we're demonstrating what might be called the fundamental algorithm of life. Repeat what works.

2011

9. Picking tech stocks is difficult but could be profitable

Mr. Buffett and Mr. Munger, if you were going to live another 50 years, and we sincerely hope you do, and could add one additional sector or asset class to your circle of competence, which sector would it be and why?

WARREN BUFFETT: Well, that's a very good question, and I particularly like the preamble. (Laughter) Well, you would — you would certainly pick a sector that's large, because it isn't going to make any difference to Berkshire if we get to be experts on some tiny little industry or business. I would say that — that, you know, it would have to be something in the — this isn't going to happen — **but if I could really become expert — and I mean really expert, knowing more than most — almost anybody else about the subject — in the tech field, you know, I think that that would be terrific.**

It isn't going to happen, but it's going to be a huge field. There are likely to be, you know, a few enormous winners, a lot of disappointments. So that the ability to pick the winners, you know, is far disproportionate to the ability to pick the winners, we'll say, among integrated major oil companies where they're all equated in price. You're not going to have a big edge in trying to pick Chevron against Exxon against Continental and Occidental, and you name it.

But the degree of disparity in results among larger tech companies in the future is likely to be very, very dramatic. And if I had the skills where I could pick the winners there I would do a lot better than if I had the skills to pick the winners in the major integrated oil field. You probably will have better luck with Charlie on this one because he knows a lot more about a lot of industries than I do. Charlie, what's your answer?

CHARLIE MUNGER: Well, it would either be tech or energy. And I think that we're the wrong people to develop the expertise.

IV is always a Range

We never — we — if Charlie and I had to stick a number in an envelope in front of us as to what we thought the intrinsic value of Berkshire was, well, neither one of us would stick a figure, we'd stick a range, because it would be ridiculous to come up with a single specific number, which encompasses not only the businesses we own, but what we're going to do with the capital in the future. But even our ranges would differ modestly, and they might differ tomorrow, in terms of how I would feel versus today, but not dramatically at all.

12. Buffett is always optimistic about American capitalism

"Whenever you talk in a general way about America's economic future, your remarks are invariably positive, even glowing, despite the severe problems of growing public and private debt, the huge budget imbalances that result, and no real policies to solve these problems."

WARREN BUFFETT: That's from Charlie's good friend as well, Dick Holland, who we both have known for 60-plus years. I don't see how anybody can be other than enthused about this country. If you look back to 1776 or 1789, whichever one you want to date it from, you know, it has been the most extraordinary economic period in the history of the world. In fact, if you go back — **I was born on August 30th, 1930. Now, if somebody had come to me**

in the womb and said, "Let me tell you what it's like outside now. The stock market has just crashed, but you haven't seen anything yet. 4,000 banks are going to fail.

"The Dow Jones average is going to go down to 42. It was 381 back just a little bit before you were conceived, and it's going to go to 42. They're going to close the banks for a while. We're going to have 25 percent unemployment. We're going to have the dust bowl in the Midwest. The grasshoppers are going to take over."

You know, it would be like in that Woody Allen movie where he says, "Go back, go back." All that's happened since August 30th, 1930, is that the standard of living of the average American has increased six-for-one. Six-for-one. You know, that's absolutely incredible. I mean, you look at centuries where nothing happened for the average person. I mean, century after century. So we have a system that works magnificently. It gets gummed up periodically. And it always has troubles. I mean, you know, I — my father was very anti-New Deal, so my sisters and I sat around a dinner table from the first we can remember hearing how things were going to go to hell.

As a matter of fact, my father-in-law told my wife-to-be and her mother that he wanted to have a talk with me before we got married. And he was very much on my side, so I was not in a panic about this or anything, but I went down to his house shortly before the marriage and this wonderful man, Doc Thompson, sat in a chair for a couple of hours, and he said, "Warren," he said. "I just want to tell you that you're going to fail but it's not your fault." (Laughter) And he said, "You and Susie, my daughter, if you starve, she would have starved anyway. I mean, it is not your fault. It's because — you know, it's because the Democrats are in, you know, and they're going to take the country down the road to Communism and, you know, and just don't worry about the fact you're going to fail." And this went on for quite a while. And then he blessed me and we got married. It was a happy ending.

But ever since — when I got out of school in 1951, the two people I admired the most in the world, my dad and Ben Graham, both said, you know, you've got a good future but don't start in stocks now because there's never been a year when the Dow Jones average has not ended up below 200, and it's above 200 now. It's much too high, and if you start now selling stocks to people they're going to have bad experiences. So why don't you wait a while and go work in the Omaha National Bank or do something, park yourself on the sidelines. There's always negatives. The country always faces problems. I mean, this country went through, you know, it went through a civil war, you know. It — it's gone through all kinds of things. But what happens?

You know, we have a few lousy years from time to time. **We've had, probably, 15 recessions since the country started. And we will always have a list of 10 or 15 things at the start of the year that will tell you why this country can't possibly work well. But all I can tell you is that it doesn't do it in a straight line, but the power of capitalism is incredible.** I mean, you know, that's what is bringing us out of this recession. I mean, monetary and fiscal policy add some utility, and certainly in the fall of 2008 the government was needed in a huge, huge way. It could do what — it was the only one that could do what was needed.

But if you look at the history of the United States, you know, probably half of our recessions have occurred during — we'll say in the 19th century — when people didn't even know what fiscal or monetary policy was. I mean, what happened was that excesses would come in and then the resuscitative power of capitalism would set the country back on the right — on a stronger growth pattern — and that's happened time after time after time.

And the game isn't over. I mean, it is not like the potential of America has been used up. What has happened is the rest of the world has caught on, to some extent, so you're seeing some state capitalism in places like China, and they are turning economies loose that have been dormant for centuries. But it's not because the people are smarter. It's not because they work harder. It's just because they have tapped into a system that works marvelously over time. And I will tell you, in the next hundred years you're going to have probably 15, maybe as many as 20 lousy years, but we will be so far ahead of where we are now that it will be unrecognizable.

CHARLIE MUNGER: Well, I can go back a lot farther than that. You know, Europe survived the Black Death, where about a third of the people died. The world is going to go on.

13. Best assets in an inflationary environment

AUDIENCE MEMBER: Good morning. Angie Janssen (PH) of Cambridge, Massachusetts. My question is, aside from the need to put huge amounts of capital to work, do you still believe that a high return on tangible capital business, like See's or Coke, is the best asset to hold in an inflationary environment, or do you now think an irreplaceable hard asset with pricing power, like a railroad or a hydroelectric dam, is superior?

WARREN BUFFETT: The first group is superior. I mean, if you can have a wonderful consumer product — doesn't have to be a consumer product — a product that requires very little capital to grow, and to do more dollar volume, as will happen with inflation even if you don't have unit growth, and it doesn't take much capital to support that growth, that is a wonderful asset to have in inflation. I mean, the ultimate test of that is your own earning ability. I mean, if you're an outstanding doctor, lawyer, whatever it may be, teacher, the — you — as inflation goes along, your services will command more and more in dollar terms, and you don't have to make any additional investment in yourself.

People think of that, you know, with a very long-lived real estate asset or something of the sort, or a farm, or anything where additional capital is not required to finance inflationary growth. The worst kind of businesses are the businesses with tons of receivables and inventories and all of that. And in dollar terms, if their volume stays flat but the price level doubles, and they need to come up with double the amount of money to do that same volume of business, that can be a very bad asset.

Now normally, we are not enthused about businesses that require heavy capital investment, just like utilities and the railroad. We think that, on the other hand, particularly with the railroad, that where you do not have any guaranteed lower rate of return, that you should be entitled to earn returns on assets that are becoming more and more valuable to the economy as — whether it's because of inflationary factors or because of just natural growth factors, or in the case of the United States, I think it will be both.

But the ideal business — See's Candy is doing — it was doing $25 million of volume when we bought it, and it sold 16 million pounds of candy — a little more than — well, it retails $1.90, and we had some quantity discounts, so we were doing close to $30 million worth of business. Now, we're doing well over $300 million worth of business. It took $9 million of tangible assets to run it when it was doing 30, and it takes about 40 million of tangible assets at 300-and-some. So we've only had to ploy back $30 million into a business which will make us — well, it's made us, probably, a billion-and-a-half pretax during that period. And if the price of candy doubles, we don't have any receivables to speak of. Our inventory turns fast. We don't store it or anything like that. We gear up seasonally and the fixed assets aren't big, so that is a much better business to own than a utility business if you're going to have a lot of inflation.

CHARLIE MUNGER: And what's interesting about it is that we didn't always know this.

WARREN BUFFETT: Yeah, and it does show — you know, I've said in the past that I'm a better businessman because I'm an investor and I'm a better investor because I'm a businessman. There's nothing like actually experiencing the necessity, particularly in the 1970s when inflation was gathering strength, and early '80s, you would see this absolutely required capital investment on a very big scale that really wasn't producing anything commensurate in the way of earnings. I wrote an article for Fortune called "How Inflation Swindles the Equity Investor" back in 1977. You really want — the ideal asset, you know, is a royalty on somebody else's sales during inflation, where all you do is get a royalty check every month, and it's based on their sales volume.

And you made — you came up with some product originally, licensed it to them, and you never have another bit of capital investment. You have no receivables, you have no inventory, and you have no fixed assets. That kind of business is real inflation protection, assuming the product maintains its viability. So even though we are going into some very capital-intensive businesses, part of that reflects the fact we can't deploy the amount of capital we have in a whole bunch of See's Candies. We just can't find them. We would love to find them, but we can't find them in that quantity.

15. Still bullish on bank stocks Wells Fargo and U.S. Bancorp

WARREN BUFFETT: Yeah, Wells Fargo and U.S. Bancorp are both among the best large banks, if not the best, in the country and they're different than what you think of in terms of some money center banks, but they're very large. Wells is four times as large as USB. Banking as a whole — U.S. banking — profitability will be considerably less, in my view, in the period ahead than it was, say, in the early part of this century. And a very important reason is that the leverage will be reduced. And that's probably a good thing for society.

The — so I would say that return on assets — even if return on assets were as good as it was some years ago, there will be less assets per dollar of common equity than before which means returns on common equity will be less. We still think that Wells Fargo and U.S. Bank are very good operations. We think they're very decent businesses. They're not as attractive as when leverage ratios could be higher.

And banks periodically go crazy. It's always on the asset side. I mean, here you've got cheap money. You've got the federal government behind, although the federal government has never had to pay out anything on — in terms of the FDIC. The FDIC has handled 3800 since it was established on January 1, 1934. The FDIC has paid out probably 3800, 3900 by now, institutions, 250 of them or so in the last couple years. And that has not cost the U.S. taxpayer a penny. I mean, that has all come from FDIC assessments on other banks. It's been a mutual insurance company.

Banking, if you just keep out of trouble on the asset side, is a very good business because you get your money so cheap and, you know, because of the implicit federal guarantee, and you do get to leverage up to a fair extent, and America's been a pretty good place to lend money. So I like our positions in there. You will see that — if you looked at those totals — you'll see we've added to Wells Fargo. And both those companies are very well run institutions, but they will not be able to earn — I don't know what the figures were, but I think they were up 25 or — to 30 percent on tangible equity — and that's not going to get repeated in the future, and it shouldn't be.

CHARLIE MUNGER: Well, yeah, we might add that M&T Bank, which most people —never talk about, is headed by a really sensible fellow, and it's been a wonderful investment for us.

WARREN BUFFETT: Yeah, as a matter of fact, if you get the M&T annual report, it's written by Bob Wilmers, the letter, the first part of it is about M & T specifically, but the second part is about particularly the American financial economy, and I would really recommend you read that. Bob is a very smart guy and he has a lot of good observations. And, frankly, the other one I recommend you read is Jamie Dimon's letter, at JPMorgan, is a tour de force, in terms of describing the banking scene, the economic scene. He has some real insights in there about some very important subjects. We don't own that stock, but it's a letter that I think everybody could learn a lot from reading, as they could from reading Bob Wilmer's letter at M&T.

Three Categories of Investment

But if you think about it, there are three major categories of investment. And you ought to think very hard about which category you want to be in before you start thinking about the choices available within that category.

Now, the first category is anything denominated in a currency. It could be bonds, it could be deposits in a bank, it can be a money market fund, it can be cash in your pocket. And the — if you will reach in your pocket — I don't like to do this, but — and pull out your wallet — you're watching an historic event. (Laughter) If you look at this — and I might point out this is a one. Charlie carries a — on the back of it, it says, "In God We Trust." And that's really false advertising. The — if Elizabeth Warren were here, she would say, quite properly, it should say, "In Government We Trust," because God isn't going to do anything about that dollar bill, you know, if government does the wrong things, in terms of keeping it as valuable as it was when you parted with it to buy a bond or put it in a bank.

Any currency-related investment is a bet on how government now, and in the future, will behave. And if you happen to be unfortunate to live — fortunate to live in Zimbabwe and you decided to make currency-related investments, you know, you — family would have left you by now, and it was not a good decision. Almost all currencies have declined in value over time. I mean, it may be built into almost any economic system that it will be easier to work with a value of currency that declines in value than a currency that appreciates in value, and the Japanese might reaffirm that here with their experience. So as a class, currency-related investments, whether they are in the UK, or the United States, or anyplace else, unless we're getting paid extremely well for having them, we do not think make much sense.

The second category of investments regard items that you buy that don't produce anything but that you hope someone will pay you more for later on. And the classic case of that is gold. All you are doing when you buy that is that you're hoping that somebody else a year from now, or five years from now, will pay you more to own something that, again, can't do anything, but you're hoping that the person then thinks that somebody else will buy something five years later from him.

In other words, you're betting on not just how scared people are now of paper money, you're betting on how much they think a year from now people will be scared two years from then on. Keynes described all of this. I think it was in Chapter 12 of "The General Theory," when he talked about this famous beauty contest where the game was not to pick out the most beautiful woman among the group, but the one that other people would think was the most beautiful woman, and then he carried it on to second and third degrees of reasoning. Any time you buy an asset that can't do anything, produce anything, you're simply betting on whether somebody else will pay more for, again, an asset that can't do anything.

The third category of asset is something that you value based on its — what it will produce, what it will deliver. You buy a farm because you expect a certain amount of corn or soybeans or cotton or whatever it may be, to come your way every year. And you decide how much you pay based on how much you think the asset itself will deliver over time. And those are the assets that appeal to me and Charlie. Now, there's some logical follow-on to that. If you buy that farm, and you really think about how many bushels of corn, how much bushels of soybeans will it produce, how much do I have to pay the tenant farmer, how much do I have to pay in taxes and so on, you can make a rational calculation, and the success of that investment will be determined in your own mind by whether it meets your expectations as to what it delivers.

Logically, you should not care whether you get a quote on that farm a day later, or a week later, or a month later, or a year later. We feel the same way about businesses. When we buy ISCAR, or we buy Lubrizol, or whatever, we don't run around getting a quote on it every week and say, you know, "Is it up or down or anything like that?" We look to the business.

We feel the same way about securities. When we buy a marketable security, we don't care if the stock exchange closes for a few years. So when we look at Berkshire, we are looking at what we think can be delivered from the productive assets that we own, and how we can utilize that capital in acquiring more productive assets. And there will be times, you know, cotton doubled in price, much to our chagrin at Fruit of the Loom, but, you know, if you own cotton for the right six or eight months in the past year, you came close to doubling your money.

But if you go back a century and try to make money owning cotton over time, it has not been a very good investment. So to pick a product, crude oil, cotton, gold, silver, anything that — and, of course, cotton has utility. Gold really doesn't have utility.

I would bet on good-producing businesses to outperform something that doesn't do anything over any period of time. But there's no question that rising prices create their own excitement. So when people see gold go up a lot — I mean, if your neighbor owns some gold, and you think you're smarter than he is, and you didn't own any, and your wife says to you, you know, "How come that jerk next door is making money, you know, and you're just sitting here?" It can start affecting behavior. And people like to get in on things that have been rising in price and all of that. But over time, that has not been the way to get rich.

WARREN BUFFETT: One thing about gold, also, is that in addition to this 67-foot cube, more gold is being produced every year. So you have to have buyers not only to offset sellers in the natural course of events, but you have to absorb something like a hundred billion dollars' worth of added items of no utility. I mean, it's really interesting. I mean, they dig it up out of the ground in South Africa, and then they ship it to the Federal Reserve in New York and they put it back in the ground. I mean, if you were watching this from Mars you might think it was a little peculiar. But think of how many people it makes happy.

I might mention that the value of that cube, all the gold in the world, is now about — valued at 1500-plus — it's about $8 trillion. And there are a billion acres, roughly, of farmland in the United States. That's a little a million-and-a-half square miles. And that's valued at something over 2 trillion.

And if you take ten Exxon Mobils, you get up, maybe, another 4 trillion and — maybe not that much even — and so you could own all the farmland in the United States, every bit of it, and you could own ten Exxon Mobiles and you could stick a trillion or so in your pocket for walking around money, and you could have your choice of that or this 67-foot piece of gold that you could fondle and — (Laughter) That may seem like a close choice to some people, but not to me.

17. Buffett on getting his first investors

Mr. Buffett and Mr. Munger, when you were raising your first investment funds, how did you go about attracting investors, and once you had your first funds and your first investors, how did you go about growing them?

WARREN BUFFETT: Sounds to me like a man that's about ready to start a hedge fund. (Laughter) The — in my case, I'd moved back here from New York in March or so of 1956, and a few members of my family said we'd like you to manage our investments just like I did when I was selling securities out here before I went to New York. And I didn't like being in the securities selling business, partly because if I sold somebody a stock at 20 and it went down to 10, I wanted to buy more, but I couldn't face the idea of people that had bought at 20 and, based only on confidence in me not because they understood it, and now they were feeling depressed, and it was — it just wasn't — it wasn't very satisfactory.

I could not do as well managing money if people were watching every decision as I could if I did it in a room all by myself. So I just told these seven members of the family — one of them, actually, was my roommate in college and his mother, they came in also — I said, you know, if you'd like to join up in a partnership, I'm not going to tell you what's going on, but I will tell you that I will be doing with my own money what I'm doing with yours. Later on, I put all my own money in.

And it just was very slow. A few months later, Graham-Newman, that I'd worked for, was liquidating, and a fellow named Homer Dodge asked Ben Graham what he should do with the money he was getting out of Graham-Newman. He said, "This kid used to work for me and he's OK." And so he came out and went in with me.

And another fellow, late in the fall, had seen the notice of partnership formed in some legal paper and he said, "What's this?" and came in with me. It's just — we just stumbled along. And for almost six years, I operated out of my house, no employee. I kept all the books, I filed the tax returns, I, you know, went out and picked up the stocks personally and stuck them in a safe deposit box.

Active Returns

CHARLIE MUNGER: I don't think the average return of a skilled investor over the next 50 years is going to be as good after all factors as it was over the last 50 years. So I think reduced expectations are the best defense any investor has, and after that, I think Berkshire is a pretty good bet.

Secret to Success

CHARLIE MUNGER: Yeah. Sir William Osler, who created a model medical school for the world, used to say that the secret of success in a field is getting very interested in it.

14. "Forget about goodwill" when evaluating a business

WARREN BUFFETT: Yeah, goodwill — you mention AOL-Time Warner or something of the sort, it should be written off, actually. It was just a mistake in purchase price. **Goodwill should not be used in evaluating the fundamental attractiveness of a business. There you should look at return on tangible assets, and even then there's some minor — some other adjustments you may want to make. But basically, in evaluating the businesses we own, in terms of what the management are doing and what the underlying economics of the business are, forget about goodwill. In terms of evaluating the job we're doing in allocating capital, you have to include goodwill, because we paid for it.**

So if we buy — you know, Coca-Cola goes back to 1886 and John Pemberton at Jacobs Pharmacy in Atlanta, and there was not a whole lot of goodwill put on the books when he sold that first Coca-Cola. If you were to buy the company now, the whole company, you'd be putting a figure, you know, of 100 billion or something like that on it. You shouldn't amortize that, and you shouldn't, in judging the economics of the business, look at that.

But in terms of judging the economics of the business that purchased it — we'll call it Berkshire — then you have to allow for the goodwill, because we are allocating capital and paying a lot for it. I don't think the amortization of goodwill makes any sense. I think write-offs of it, when you find out you've made the wrong purchase and the business doesn't earn commensurate with the tangible assets employed plus the goodwill, I think write-offs of it make sense. **But when looking at businesses as to whether they're good businesses, mediocre businesses, poor businesses, look at the return on net tangible assets.**

CHARLIE MUNGER: Well, I think that's right. But as the gentleman says, when we buy a business, a whole business, we never get a huge bargain and, of course, we may get down toward 10 percent pretax earnings on what we pay. That isn't so awful as you think when you — a lot of the money comes from insurance float that costs you nothing. In other words, if you have 60 billion of float and God gives you 6 billion a year earnings, it's not all bad.

WARREN BUFFETT: Well, on Lubrizol we're paying close to 9 billion for the equity, and it earns — and you should make adjustments for debt but it's not an important factor there — and, you know, current rate of earnings is probably a billion pretax. And now Lubrizol itself is employing far — you know, they're employing, you know, call it 2 1/2 billion of equity to earn that billion of pretax, so it's a very good business, in terms of the assets that are employed. But when we end up paying the premium we pay to buy into it, it becomes a billion pretax on something close to 9 billion. You have to judge us based on close to a $9 billion investment. You have to judge James Hambrick in running the business based on the much lower capital that he has employed. It can turn out to be a very good business, and we could turn out to have made at least a minor mistake if it isn't as good a business as we think it is now, but still is a very satisfactory business based on the tangible capital employed.

16. Incentivizing kids

AUDIENCE MEMBER: Sumat Mehra (PH) from Kashmir in India. Mr. Buffett, hope you enjoyed your first trip to India. One of the most important things that drive people are incentives, but if you live in a rich society it's very hard to get your kids to work hard and reach their full potential because they just don't need to. How would you incentivize him or her to compete among the hungry and highly motivated kids from emerging markets like China, Brazil, Russia, or India?

WARREN BUFFETT: I think certainly that if you are very rich and you bring up your kids to think that they are more important in society, or that they have some special privilege, simply because they came out of the right womb, that, you know, that's just a terrible mistake. But Charlie has raised eight children that I know quite well, most of them, and I don't think any of them have that sense. But it's — if you really are going to raise your kids to think that other people should do all the work for them and that they will be entitled to sit around and fan themselves for the rest of their lives, I mean, you know, you will probably not get a good result. I — you know, in my — Charlie has been rich most of the time when his kids — many of his kids — were growing up — some of his kids were growing up,

I've been rich while my kids were getting — certainly when they got into high school and college — but I don't think — I certainly didn't want to give them the idea that they were special just because their parents were rich. And I don't think you necessarily have to get a bad result or have children that don't have any incentives simply because their parents are rich. The one thing I don't think you want to give them an incentive to do is try and outdo their parents at what their parents happen to be good at. I don't think that makes sense, whether if you are a professional athlete, or a rich person, or whatever it may be, a great novelist, you name it. But I really think if you're rich and your kids turn out to have no incentives, I don't think you should point at them. I think you should probably point at yourself.

CHARLIE MUNGER: Well, I don't think you can raise children in an affluent family and have them love working 60 hours a week in the hot sun digging fence post holes or something. That's not going to work. So to some extent, you are destroying certain kinds of incentives. And my advice to you is to lose your fight as gracefully as you can. (Laughter)

WARREN BUFFETT: I'm not sure if you're poor if you can get your kids to love the idea of working 60 hours a week. They may have to, but —

CHARLIE MUNGER: Kids that really get interested in something will work no matter how rich they are. But it's rare to have an Ajit-like intensity of interest.

Economics

CHARLIE MUNGER: Yeah, **I think economics is a really tough subject, and I think it's easy to teach the basic microeconomics and certain of the basic ideas, but the minute it gets into the full range of complexity, you have the difficulty that the experts disagree. So, I don't think I would hurry if I were trying to learn something into the parts of the fields where none of the experts can agree among themselves. I would master the easy stuff first.**

WARREN BUFFETT: Yeah, I don't think — yeah, I would not advise taking lots of courses in economics to somebody going to school. I'm just trying to think back. It's been a long time since I took my economics courses at Wharton, but I don't regard them as the ones that pushed me forward in any significant way.

2012

11. U.S. banks are in better shape European banks

WARREN BUFFETT: Well, I have a decidedly different view on European banks than American banks. The American banks are in a far, far, far better position than they were three or four years ago. They've taken most of the abnormal losses that existed, or that were going to manifest themselves, in their portfolios from what's now 3 1/2 or four years ago.

They've buttressed their capital in a very big way. They've got liquidity coming out their ears at the bigger banks. The American banking system is in fine shape. The European banking system was gasping for air a few months back, which is why Mr. Draghi opened up his wallet at the ECB and came up with roughly a trillion euros of liquidity for those banks. Now a trillion euros is about $1.3 trillion, and $1.3 trillion is about one-sixth of all the bank deposits in the United States. I mean, it was a huge act by the European Central Bank, and it was designed to replace funding that was running off from European banks. European banks had more wholesale funding than American banks, on average.

If you look at the Bank of America or Wells Fargo, they get an enormous amount of money from a natural customer base. European banks tended to get much more of it on a wholesale basis, and that money can run pretty fast. So the European banks need more capital in many cases. They've done very little along that line.

CHARLIE MUNGER: Yeah. Europe has a lot of problems we don't. We've got this full federal union, and the country that runs the central bank can print its own money and pay off its own debt and so on. And in Europe, they don't have a full federal union and that makes it very, very difficult to handle these stresses. So we're more comfortable with the risk profile in the United States.

WARREN BUFFETT: It's night and day. I mean, it — in the fall of 2008, when essentially Bernanke and Paulson, and implicitly, the President of the United States, said we'll do whatever it takes, you knew that they had the power, and the will, to do whatever it took. But when you get 17 countries that have surrendered their sovereignty, as far as their currency is concerned, you know, you have this problem. Henry Kissinger said it a long time ago. He said, "If I want to call Europe, what number do I dial?"

You know, and when you have 17 countries and — just imagine if we'd had 17 states in 2008, and we had to have the governors of those states all go to Washington and agree on a course of action when money market funds were — there was a panic in there, the panic in commercial paper, you name it — we would have had a different outcome. So I would put European banks and American banks in two very different categories.

24. Take advantage when "Mr. Market" acts like a "psychotic drunk"

But the important thing is that you make your decisions based on what you think the business is worth. And if you make your buy and sell decisions based on what you think a business is worth, and you stick with businesses that you think — you've got good reason to think — you can value, you simply have to do well in stocks. The stock market is the most obliging, money-making place in the world because you don't have to do anything.

If you own a farm and the guy has the farm next to you and you'd kind of like to buy him out or something, he's not going to name a price every day at which he'll buy your farm or sell you his farm, but you can do that with Berkshire Hathaway or IBM. It's a marvelous game. The rules are stacked in your favor, if you don't turn those rules upside down and start behaving like the drunken psychotic instead of the guy that's there to take advantage of it.

28. Different valuation methods for different companies

JAY GELB: Warren, when you discuss Berkshire's intrinsic value, why do you value the insurance business at only cash plus investments per share? And what's a reasonable multiple to apply to the pretax earnings of the noninsurance businesses?

WARREN BUFFETT: I would — I don't value the insurance business quite the way you say it. I would value GEICO, for example, differently than I would value Gen Re, and I would value even some of our minor companies differently. But basically, I would say that GEICO is worth — has an intrinsic value — that's greater — significantly greater — than the sum of its net worth and its float. Now, I wouldn't say that about some of our other insurance businesses. But that's for two reasons. One is, I think it's quite rational to assume a significant underwriting profit at GEICO over the next decade or two decades, and I think it's likely that it will have significant growth.

And both of those are value — items of enormous value. So that adds to the present float value, but I can't say that about some other businesses. But in any event, once you come up with your own valuation on that, in terms of the operating business, obviously different ones have different characteristics. But I would love to buy a new bunch of operating businesses that had similar competitive positions in everything.

Under today's conditions, I would love to buy those at certainly nine times pretax earnings, maybe 10 times pretax earnings. I'm not talking about EBITDA or anything like that, which is nonsense. I'm talking about regular pretax earnings. If they have similar characteristics, we'd probably pay a little more than that, because we know so much more about them than we might know about some other businesses. What would you say, Charlie?

CHARLIE MUNGER: When you used the word EBITDA, I thought to myself, I don't even like hearing the word. (Laughter) There's so much nutcase thinking involving EBITDA. Earnings before what really counts in costs.

WARREN BUFFETT: It's nonsense. I mean, if you compare a business that, you know, leases pencils or something like that where they all get depreciated in a two-year period and then compare that to some business that uses virtually no capital, you know, like See's Candies, it's just nonsense. But it works for the people that sell businesses.

31. Why is BNSF a subsidiary of National Indemnity?

GARY RANSOM: When Berkshire bought BNSF, it raised the surplus of the property-casualty industry by about 4 percent. It's unusual to have a property-casualty company own such a large non-operating company. I'd also characterize your whole organization chart as challenging, a lot of different pieces to it, which gives rise to the issue of capital efficiency. And I'm just wondering, are there any parts of your organization structure that have any hindrance, whether it's regulatory or otherwise, to making use of the capital in the best way, generally, and in particular for BNSF?

WARREN BUFFETT: Yeah. **Well, I would say that money in our life companies has less utility to us — I'd rather have $100 million in our property-casualty companies than 100 million in our life companies, because we're more restricted as to what we can do with the money in the life companies.**

So — and we've got a fair amount of money in life companies, and that money cannot be used as effectively over a period of years, in my view, as money we have in the property-casualty business. It's a disadvantage to being in the life business versus the PC business. **And the best place — obviously, the number one place where we like to have money is in the holding company. And we've got about 10 billion in the holding company right now. That, you have the ultimate flexibility with.**

Most of our operating businesses keep more cash around than they need, but it's there. And I'm — as long as I have 20 billion someplace, I feel comfortable. We'll never have anything that can come up, remotely, that would cause me to lose any sleep as long as I start with the 20 billion. That's probably considerably more than we need, but it just leaves us comfortable, and it makes us feel we can do other things aggressively, as long as we know the downside is protected.

The — having the railroad in National Indemnity was just something we thought was nice to have a huge asset like that there that should make the rating agencies and everyone feel comfortable, and there's no disadvantage to us. Very interesting, the rating agencies — at least one rating agency — said they didn't want to give us any credit for that asset in there, although if we had 20 percent, like we had had earlier, they would have given us full credit for the market value. I didn't push them too hard on that. But there's a fair amount of logic, I think, to where things are placed. If we were to make a big acquisition, it might require shifting some funds from one place to another, but we'll always leave every place more than adequately capitalized.

CHARLIE MUNGER: **Well, two things are peculiar about that casualty operation. One is that it has so much more capital, in relation to insurance premiums, than anybody else.** And the other is that it has, among the assets in that great surplus of capital, is something like the Burlington Northern Railroad, which makes it immensely stronger from the viewpoint of the policyholder. It's a huge advantage you're talking about, not a disadvantage.

WARREN BUFFETT: Yeah. **Here's a property-casualty company that has an asset in it that, unrelated to insurance, will probably make $5 billion pretax or more. So if we're writing — well, in that entity, we're writing less than that — but let's say we're writing 25 billion of premiums. That means we can write at 120, and just our railroad operation will bring us an underwriting neutrality. I mean, it's a terrific — it's like having a royalty or something.**

33. Buffett sees value in local newspapers

"You've described the newspaper business in the past as chopping down trees, buying expensive printing presses, and having a fleet of delivery trucks, all to get pieces of paper to people to read about what happened yesterday. "You constantly mention the importance of future intrinsic value in evaluating a business or company. With all of the new options available in today's social media and the speculation of the demise of the newspaper media, why buy the Omaha World-Herald?" "Was there some" — this is a question from the other one — "Was there some self-indulgence in this?"

WARREN BUFFETT: No, I would say this about newspapers. It's really fascinating, because everything she read is true, and it's even worse than that. (Laughter) **The newspapers have three problems, two of which are very difficult to overcome, and one, if they don't — the third — if they don't overcome it, they're going to have even worse problems, but maybe can be overcome.**

Newspapers — you know, news is what you don't know that you want to know. I mean, everybody in this room has a whole bunch of things that they want to keep informed on. And if you go back 50 years, the newspaper contained dozens and dozens and dozens of areas of interest to people where it was the primary source. If you wanted to rent an apartment, you could learn more about renting apartments by looking at a newspaper than going anyplace else. If you wanted a job, you could learn more about that job. If you wanted to know where bananas were selling the cheapest this weekend, you could find it out. If you wanted to know how — whether Stan Musial, you know, went two for four, or three for four, last night, you went to the newspapers.

If you wanted to look at what your stocks were selling at, you went to the newspapers. Now, all of those things, which are of interest to many, many people, have now found other means — they've found other venues — where that information is available on a more timely, often cost-free, basis.

So newspapers have to be primary about something of interest to a significant percentage of the people that live within their distribution area. And the — there were so many areas where they were primary 30 or 40 years ago that you could buy a newspaper and only use a small portion of it and it still was valuable to you. But now you

don't use a newspaper to look for stock prices. You get them instantly off the computer. You don't look for the newspapers for apartments to rent, in many cases, or jobs to find, or the price of bananas, or what happened in the NFL yesterday.

So they've lost primacy in all of these areas that were important. They still are primary in a great many areas. The World-Herald tells me, every day, a lot of things that I want to know that I can't find someplace else. **They don't tell me as many things as they did 20 or 30 or 40 years ago that I want to know, but they still tell me some things that I can't find out elsewhere.**

Most of those items — overwhelmingly — those items are going to be local. You know, they're not going to tell me a lot about Afghanistan or something of the sort that I want to know but I don't know. I'm going to get that through other medium. But they do tell me a lot of things about my city, about local sports, about my neighbors, about a lot of things that I want to know. And as long as they stay primary in that arena, they've got an item of interest to me.

Now, the problem they have, they are expensive to distribute, as the questioner mentioned. And then the second problem is that, throughout this country, we had 1700 daily newspapers. We have about 1400 now. The — in a great many cases, they are going up on the web and giving free the same thing that they're charging for in delivery. Now, I don't know of any business plan that has sustained itself for a long time, maybe you can think of — maybe Charlie can think of one — but that has charged significantly in one version and offers the same version free to people, that had a business model that would work over time.

And lately, in the last year even, many newspapers have experimented with, and to some extent succeeded, in those experiments, in getting paid for what they were giving away on the net that otherwise they were trying to charge for in terms of delivery. I think there is a future for newspapers that exist in an area where there's a sense of community, where people actually care about their schools, and they care about what's going on in the given geographic area. I think there's a market for that. It's not as bullet proof, at all, as the old method when you had 50 different reasons to subscribe to the newspaper.

But I think if you're in a community where most people have a sense of community, and you don't give away the product, and you cover that local area in telling people about things that are of concern to them, and doing that better than other people, whether it be high school sports, you know. I've always used the example of obituaries. I mean, people still get their obituaries from the newspaper. It's very hard to go to the internet and get obituaries.

But I'm interested in Omaha and knowing who's getting married, or dying, or having children, or getting divorced, or whatever it may be. When I lived in White Plains, New York, I really wasn't that interested in it. I did not feel a sense of community there. So we have bought — and we own a paper in Buffalo where there's a strong sense of community, and we make reasonable money in Buffalo. It's declined, and we have to have a internet presence there where people have to pay to come on. We have to develop that.

But I think that the economics, based on the prices we paid — and we may buy more newspapers — I think the economics will work out OK. It's nothing like the old days, but it still fulfills an important function. It's not going to come back and tell you what your — and tell you on Wednesday what stock prices closed at on Tuesday and have you rush to the paper to find out. It's not going to tell you what happened in basketball last night when you've gone to ESPN.com and found out about it. But it will tell you a whole lot about what's going on, if you're interested in your local institutions. And we own papers in towns where people have strong local interest.

34. Buffett: Amazon won't affect Nebraska Furniture Mart

CLIFF GALLANT: Thank you. Just on that general topic, it is true that in the past some of your investments have been fairly affected by technology, in newspapers or World Book. Are there other businesses where you're concerned about technology affecting them, for example, you know, Amazon or online grocery stores? Could they affect a business indirectly, like McLane?

WARREN BUFFETT: Amazon is a tough one to figure. I mean, Amazon — it could affect a lot of businesses that don't think they're going to be affected today in the retailing area. It's huge. It's a powerhouse. I don't think it's going to affect a Nebraska Furniture Mart, but I think it could affect some of the other retailing operations THAT we have. It won't affect the Nebraska Furniture Mart. I should report to you that in the first four days: Tuesday, Wednesday, Thursday, and Friday of this week, our business at the Furniture Mart is up about 11 percent over last year, so you people are doing your part there.

We had — on Tuesday we did over $6 million of business. Now, those of you who are in the retailing business, thinking about a Tuesday and 6 million-plus of volume, we'll do more probably today, but those are huge, huge volumes. And we're going to go to Dallas here in a couple of years. We've got a 433-acre plot of ground down there, and I think we're going to have a store that will make any records we've set in the past look like nothing.

Going back to Amazon, though, in terms — GEICO was very affected by the internet, and at first, we missed that. I mean, we — GEICO's got an interesting history. It was mail originally, if you go back into the late '30s and early '40s, and it was very successful. And then it moved — not leaving mail totally behind — but it moved to television big time.

And then the internet came along, and I thought, originally, that only young people would look for quotes on the internet and that — you know, I mean, I never would have done it. I would have been calling on a rotary dial phone, you know, and saying — when they said number, please, first, I have to get my quote on GEICO — forever. But it just changed dramatically, you know, to the internet.

So, things do change very significantly, and if the consumer finds something they like to do better in some new way — and Amazon has been an incredible success. It's very hard to find people who have done business with Amazon that are unhappy about the transaction. They have happy customers. And a business that has millions and millions of happy customers can introduce them to new items and then, you know, and it will be a powerhouse, and I think it could affect a lot of businesses. It's hard for me to figure out.

CHARLIE MUNGER: **I think it's almost sure to hurt a lot of businesses a lot.**

WARREN BUFFETT: Which ones do you think it will hurt the most, Charlie?

CHARLIE MUNGER: **Well, anything that can be easily bought by using a home computer, or an iPad, for that matter.**

WARREN BUFFETT: Which of our businesses do you think it can hurt?

CHARLIE MUNGER: I won't be buying the stuff because I'm habit bound. Besides, I almost never buy anything. (Laughter) But I think it will hugely affect a lot of people. I think it's terrible for most retailers. Not slightly terrible, really terrible.

Understanding a Business

WARREN BUFFETT: Yeah, well. We — I think I would describe it as we try to stay away from the things, to start with, that we don't understand. And when I say don't understand, it isn't that I don't understand, you know, what a certain business does. But when I say understand, it means that I think I have a reasonably — a reasonable fix on about what the earning power and competitive position will look like in five or 10 years. So I've got some notion of how the industry will develop and where the company will stand within the industry.

Well, that eliminates a whole bunch of things. And then, beyond that, if the price is crazy, even though I understand it, that eliminates another bunch. So you get down to a very small universe, and you get down to a particularly small universe when we're working with lots of money, as we are now.

Copying

CHARLIE MUNGER: And the other thing that is, I think, helpful in reverse, is — as a place to look, looking at things that other smart people are buying. That is not a crazy search method as a sorting device for opportunities to consider.

WARREN BUFFETT: Charlie knew me when, I used to look at — I grabbed the Graham-Newman reports as fast as they would come out. (Laughs) You know, if Graham Newman was doing something, it was certainly worth my time to look at it.

9. Won't invest in Apple or Google, but wouldn't bet against them

Given that you're now in IBM, are there any other entrenched leaders in technology that are, to use one of your terms, inevitable, in the same way that Coke and Gillette were? For example, is Google inevitable? Is it reminiscent of the advertising agencies you owned in the 1970s, i.e., a toll bridge on all digital spending that's highly likely to keep growing over time? What are the one or two things about Google, for example, that you think are real risks? And what about Apple?

WARREN BUFFETT: Well, those are extraordinary companies, obviously, and both — they're both huge companies. They make lots of money. They earn fantastic returns on capital. **They look very tough to dislodge, where they have their strengths. You know, I would not be at all surprised to see them be worth a lot more money 10 years from now, but I wouldn't want to buy either one of them. I do not get to the level of conviction that would cause me to buy them. But I sure as hell wouldn't short them, either.**

CHARLIE MUNGER: **Well, I think we can fairly say that other people will always understand those two companies better than we do. We have the reverse of an edge. And we're not looking for that.**

WARREN BUFFETT: Yeah. The chances of being way wrong in IBM are probably less, at least for us, than being way wrong with Google or Apple. But that doesn't mean that those — the latter two companies —aren't going to do, say, far better than IBM. But we wouldn't have predicted what would happen with Apple 10 years ago. And it's very hard for me to predict, you know, what will happen in the next 10 years. They're certainly — you know, they've come up with these brilliant products. There's other people trying to come up with brilliant products. I just don't know how to evaluate the people that are out there working, either in big companies or in garages, that are trying to think of something that will change the world the way they have changed it in recent years.

2013

"You have to be" — you have said, "You have to be wildly optimistic to believe that corporate profits, as a percent of GDP can, for any sustained period, hold much above 6 percent." Corporate profits are now greater than 10 percent of GDP. How should we think about that?

CHARLIE MUNGER: **Well, I wouldn't be too surprised if that 6 percent figure turned out to be on the low side, in the estimate. Just because Warren thought something 20 years ago, doesn't mean it's a law of nature.**

20. Dangers when Fed reverses economic stimulus

And the bank reserve positions are incredible. I mean, Wells Fargo is sitting with $175 billion at the Fed earning a quarter of a percent, and really earning nothing, after attendant expenses. So, there's all this liquidity that's been created. It hasn't really hit the market because the banks have let it sit there.

You know, in classical economics, you know, that's how you juice the economy, and you pushed it out by having the Fed buy securities and create reserves for the banks and all of those things. But, believe me, the banks want loans. I mean, they are not happy — Wells is not happy — having 175 billion at the Fed, and they're looking every place they can to get it out, with the proviso that they hope to get it back from whoever they get it out to, which can slow down a bank at times.

But it— we really are in uncharted territory. I've got a lot of faith in Bernanke. I mean, he — if he's running a risk, he's running a risk he knows and understands. It won't be when they start selling. It'll be — when the market gets a — any kind of a signal — that maybe just the buying ends, maybe that selling will take place, you know, it's likely to be the shot heard around the world.

Now, that doesn't mean the world will come to an end, but it will certainly mean that everybody that owns securities and who's felt that they've been driven into them by extremely low rates or that the assets have to go up in price because interest rates are so low, will start re-evaluating their hand, and people re-evaluate very fast in markets.

CHARLIE MUNGER: **Well, generally speaking, I think that what's happened in the realm of macroeconomics has surprised all the people who thought they knew the answers, namely the economists.**

Who would have guessed that interest rates could go so low and stay so low for so long? Or that Japan, a mighty, powerful nation, could have 20 years of stasis after using all the tricks in the economist's bag? **So I think given this history, the economists ought to be a little more cautious in believing they know exactly how to stay out of trouble when they print money in massive amounts.**

21. Effects of low interest rates

"How has the Fed's zero-interest policy affected Berkshire Hathaway's various business segments? For example, has it helped or hurt their operations and profitability?"

WARREN BUFFETT: Well, it's helped. You know it— interest rates are to asset prices, you know, sort of like gravity is to the apple. And when there are very low interest rates, there's a very small gravitational pull on asset prices. And we have seen that getting played out. I mean, people make different decisions when they can borrow money for practically nothing than they made back in 1981 and '2 when Volcker was trying to stem inflation and use — and the government bond rates got up to 15 percent. So, interest rates power everything in the economic universe, and they have some effect on the decisions we make.

So, if you wanted to inflate asset prices, you know, bringing down interest rates and keeping them down — at first, nobody believed they'd stay down there very long, so it reflects the permanence that people feel will be attached to the lower rates. But when you get the 30-year bond down to 2.8 percent, you know, you are — you're able to have transactions take place. It makes houses more attractive. I mean, it's been a very smart policy, but the unwind of it, you know, has got to be more difficult, by far, than buying.

34. Follow Teledyne CEO Henry Singleton's lead

CHARLIE MUNGER: Well, Henry Singleton was a genius who could play chess blindfolded just below the grandmaster level and never got less than an 800 on any complicated math or physics exam.

And, I knew him. He lived in my community. But he started as a conglomerate where he was very interested in reporting higher earnings all the time so he could keep the daisy chain going. And when he managed it on the way down, he bought in the stock relentlessly and very logically, like a great chess player should. And — but he managed those companies on a way more centralized basis than Berkshire has ever operated.

WARREN BUFFETT: **He played the public markets way better. I mean, it— We're not interested in doing that, actually. And he was incredible in that, and he made a fortune for shareholders that stayed with him.**

But he was — to some extent, he looked at the shareholder group as somebody to be taken advantage of, and he issued stock like crazy. I'll bet he did at least 50 acquisitions where— He wanted to use a very fancy price stock. He was playing the game of the '60s, and we actually have never wanted to get in that game. I mean, he promoted the stock. And, you know, he had the Litton Industries background on it, and it was a game that worked wonderfully if you didn't care about how it ended up. And so we have not played that game. He was — in terms of wanting to get Berkshire stock — you know, he essentially was going into the third stage—(laughs) — of first issuing shares at overprice, then buying it back very underpriced, and then he was going to —

CHARLIE MUNGER: — sell it to us for more than it was worth.

2. Buffett: I haven't lost any intensity

In the past, your research has been all-encompassing, whether measured in time devoted to selecting investments and acquisitions, or the intensity of analysis, your interest in the old days of knowing the slightest minutia about a company. You once said, in characterizing Ben Rosner, quote, "Intensity is the price of excellence," closed quotes.

Your research style has seemed to morph over time from a sleuth-like analysis — American Express comes into mind when you hired Jonathan's dad, Henry Brandt. You and he conducted weeks of analysis and sight visits and channel checks. Not so much in the later investments. As an example, you famously thought of making the Bank of America investment in your bathtub. There is an investment message of this transformation from being intense to less intense. Would you please explain the degree it has to do with the market, Berkshire's size, or some other factors?

CHARLIE MUNGER: Well, I think when you bought American Express for the first time, you didn't know that much about it, so, naturally, you were digging in rather deeply. The second time you bought it, I remember you got on the golf course with Olson.

WARREN BUFFETT: Yeah. And, you know, what I learned sitting with Lorimer Davidson on a Saturday at GEICO in January of 1951 is still — is useful to me, and I don't have to learn it a second time. I can build on it. But that's one of the great things about investing. I mean, the universe, there's enough in it so that you can finds lots of opportunities, but there — it's not like it's changing dramatically all the time.

3. We don't buy anything just "by the numbers"

WARREN BUFFETT: Well, we're looking at quantitative and quality — we aren't looking at the aspects of the stock, we're looking at the aspects of a business. So when Charlie and I leaf through Value Line or look at annual reports that come across our desk or read the paper, whatever it may be, that, for one thing, we have a — we do have this cumulative knowledge of a good many industries and a good many companies, not all by a long shot.

And different numbers are of different importance — or various numbers are of different importance — depending on the kind of business. We have certain things we think about when we're buying an insurance company, certain things we think about when we're buying a company dependent upon — that depended upon — brands. Some brands travel very well, Coca-Cola being a terrific example, and some brands don't travel.

And it's not because I calculate some price — precise — P/E ratio or price-book value ratio or whatever it might be. It is because I have some idea of what the company might look like in five or ten years, and I have a reasonable amount of confidence in that judgment, and there's a disparity in price and value, and it's big.

CHARLIE MUNGER: We don't know how to buy stocks just by looking at financial figures and making judgments based on the ratios. We may be influenced a little by some of that data, but we need to know more about how the company actually functions. And anything a computer could be functioned to do, in terms of screening — I know I never do it.

CHARLIE MUNGER: **People with very high IQs who are good at math naturally look for a system where they can just look at the math and know what security to buy. It's not that easy. You really have to understand the company and its competitive position, and the reasons why its competitive position is what it is, and that is often not disclosed by the math.**

WARREN BUFFETT: Yeah. It's not what I learned from Ben Graham, although the fundamentals of looking at stocks as businesses, and the attitude toward the market and all that, is absolutely still part of the catechism. But I wouldn't — I don't know exactly how I would manage money if I was just trying to do it by the numbers.

Nobody knows anything about future returns

"Do you share his view that market returns in the next few decades will be much lower than in the past few? And should we expect Berkshire's future market returns to be greatly constrained, not only by its size, but also by much lower equity returns overall?

WARREN BUFFETT: Yeah, Charlie and I don't pay any attention to macro forecasts. I have a general feeling that America will continue to work well. And I don't — you know — there's — throughout my adult lifetime, and before that, there's always been all kinds of opinions that, you know, about what's going to happen this year or the next year or anything like that. And nobody knows.

What you do know, with a very high degree of certainty, in my view, is that BNSF will be carrying more carloads 10 years from now, 20 years from now; that there will be no substitute for the service that they provide; that there will be two important railroads in the west and two important railroads in the east; and that they will have an asset that has incredible replacement value, nobody could turn out something like it, and that they'll get paid fairly for what they do. It's not very complicated. And to ignore what you know because of predictions about what you don't know, or what nobody else knows, in our view, it's just plain silly.

CHARLIE MUNGER: Yeah. But, of course, Warren, we have a lot of money. We have to do something with it. So we're going to do our thing no matter what the external climate is. If you're a busy surgeon and trying to decide whether to work two more years before you retire, then you may be more interested, and rationally so, in the new normal. And I would personally advise the guy to work an extra couple of years. (Laughter) In other words, I kind of agree with Bill Gross.

6. Influential books and early investments

I think there are a lot of small investors that would get a kick out of knowing, you know, what you invested and how you went ahead and analyzed the companies. Thank you.

CHARLIE MUNGER: Yeah. I don't think people would be greatly helped. You wouldn't recognize the names, most of them, clearly, by the partnership.

WARREN BUFFETT: — Meadow River Coal & Land. There's hundreds of them. Flagg-Utica, Philadelphia Reading Coal & Iron, you name it. I've literally owned — I bet I've owned 4- or 500 names at one time or another, but most of the money's been made in about 10 of them.

CHARLIE MUNGER: And I couldn't name 10 books either that have — that I regard as that much better than the next 10. My mind is a blend of so many books I can't even sort it out anymore. We're just about through reading the Joe Kennedy biography. You know, I'm not sure you want to emulate everything he did, but it's still interesting reading.

(Laughs) We read for the enjoyment of it. I mean, it's been enormously beneficial to us, but the reason we read is that it's fun. And, you know, it's still fun.

15. Stock strategy

My question to you is, in the past you've said for an investor, you should simply — for 99 percent of investors — you should simply stick money in an index fund and let it go and don't worry about it. Those 1 percent of investors, choose your best five stocks and put a substantial amount of money in it. I'm just wondering, how about a strategy of, perhaps, buying 20 of the best stocks in America, you know, Procter & Gamble, Coca-Cola, Johnson & Johnson, whatever, the companies that have been around for centuries — or a century or decades or whatever — and just leaving it at that. Do you think that that would outperform an index fund over the long term? And I want Charlie's opinion as well.

WARREN BUFFETT: Well, I don't know whether you're saying the 20 largest companies or the 20 best. You might get different thoughts from different people on what they are. But I think you would — probably the 20 you would pick would virtually match the results of an index fund. Who knows exactly which ones would be the best?

But the real distinction — and Graham made this in his book, basically — is between the person who is going to spend an appreciable amount of time becoming something of an expert on businesses, because that's what stocks are, or the person who is going to be busy with another profession, wants to own equities, and actually will actually do very well in equities. But the real problem they have is that they may tend to get excited about stocks at the wrong time. You know, they, really, the idea of buying an index fund over time is not to buy stocks at the right time or the right stocks. It's to avoid buying them at the wrong time, the wrong stocks. So equities will do well over time, and you just have to avoid getting — you know, getting excited when other people are excited, or getting excited about certain industries when other people are, trying to behave like a professional when you aren't spending the time and bringing what's needed to the game to be a professional.

And if you're an amateur investor, there's nothing wrong with being an amateur investor, and you just simply — you've got a very logical, profitable course of action available to you, and that is simply to buy into American business in a broadly diversified way and put your money in over time. So I would say your group of 20 will probably match an index fund, and you'll probably do well in that, and you will do well in an index fund.

20. Howard Buffett's role after his father isn't running Berkshire

Away from the accident of birth, how is Howard the most qualified person to take on this role?

WARREN BUFFETT: Well, he's not taking on the role that you described. He is taking on the role of being nonexecutive chairman in case a mistake is made in terms of who is picked as a CEO. **I don't — I think the probabilities of a mistake being made are less than 1 in 100, but they're not 0 in 100. And I've seen that mistake made in other businesses.**

So it is not his job to run the business, to allocate capital, do anything else. If a mistake is made in picking a CEO, having a nonexecutive chairman who cares enormously about preserving the culture and taking care of the shareholders of Berkshire, not running the business at all, it will be far easier to then make another change. And that — he is there as a protector of the culture, and he has got an enormous sense of responsibility about that, and he has no illusions about — at all — about running the business. He would have no interest in running the business. He won't get paid for running the business. He won't have to think about running the business.

He'll only have to think about whether the board and himself — but as a member of the board — but whether the board may need to change the CEO. And I have seen many times, really many times, over 60-plus years or — well, probably 55 years as a director — times when a mediocre CEO, likable, you know, not dishonest, but not the person who should run it, needs to be changed. And it's very, very hard to do when that person is in the chairman's position. It's not as — it's a bit easier now that you have this procedure where the board meets at least once a year without the chairman present.

That's a very big improvement, in my view, in corporate America. Because it — a board is a social institution, and it is not easy for people to come in, we'll say, to Chicago or New York or Los Angeles once every three months, have a few committee meetings, and maybe have some doubts about whether they've really got the right person running it. They may have a very nice person running it, but they could do better. But who's going to make a change? And that's the position that the nonexecutive chairman, in this case, Howard, will be in. And I know of nobody that will feel that responsibility more in terms of doing that job as it should be done than my son, Howard, you know.

WARREN BUFFETT: The example I've used in the past, I mean, that — you know, that blessed are the meek for they shall inherit the earth, but after they inherit the earth, will they stay meek? Well, that could be the problem, you know, if somebody got named CEO of Berkshire. It could be a position where people might want to throw their weight around in various ways.

21. Near-zero rates "brutal" for bonds

Basically, you know, I've written — I wrote back in 2008 to own equities. I mean, it was — equities were cheap. And you were almost certain to get killed, you know, in terms of — for at least a while — we had a promise that the Fed was going to hold rates very low, so it was a great time to own equities.

And I feel sorry for people that have clung to fixed-dollar investments, particularly short-term ones, during a period like this, and I don't know what I would do if I were in that position. So I — well, anybody I've advised, I've always felt that owning businesses certainly made sense — more sense — than fixed dollars, under most circumstances. Not every time in my life, but probably 90 percent of the time in my life, it's made more sense than owning fixed-dollar investments. And it's certainly made dramatic sense a few years ago when equities were marked down to where they were, you know, terrific buys, and where you could see the prospect that fixed-dollar investments were going to pay very little for a considerable period of time.

30. Read over your will with your adult children

And I do something else that — I find that — which I think is an obvious thing, but it's amazing to me how many don't do it. I think that your children are going to read the will someday — that's assuming you're a wealthy person — your children are going the read the will someday. It's crazy to have them read it after you're dead, for the first time. I mean, you're not in a position to answer questions then unless the Ouija board really works or something of the sort. So if they're going to have questions about how to carry out your wishes, or why you did this or that, you know, why leave them endlessly wondering after you die? So in my own case, I always have my children — I rewrite a will every five or six years or something like that — and I have them read it.

They're the executors under it. They should understand how to carry out their obligations that are embodied in the will, and they should — also, if they feel there's anything unfair about it, they should express themselves before I sign that will, and we should talk it over, and we should figure out whether they're right or I'm right, or someplace in between. So I do think it's very important in wealthy families, once the kids are of a certain age. I mean, I don't advise doing this with your 14-year-old or something, but when they get — you know, certainly by the time they're in the mid-30s or thereabouts — I think they should be participants in the will.

And I do think that if you get to be very wealthy that the idea of trying to pass on, create a dynasty of sorts, it just sort of runs against the grain, as far as I'm concerned. And the money has far more utility — you know, the last hundreds of millions or billions have far more utility to society than they would have to make — create a situation —

where your kids don't have to do anything in life except call a trust officer once a year and tell them how much money they want.

2014

Stock Compensation

But for those of you who would really — would like to know how to think about calculating dilution, Coca-Cola has regularly repurchased the shares that are issued through options. And the share count has, thereby, come down just a small bit at Coca-Cola. Not anywhere near as much as if they hadn't issued as many shares, though, in repurchased shares. **But Coca-Cola has a plan that involves 500 million shares. And they say in the annual report that they expect to issue these over approximately four years.** And then they have a further calculation between performance shares and option shares, but I'll leave that out. Make this a little simpler. And that's a lot of shares.

Let's assume for the moment that Coca-Cola's selling around $40 a share now, which it is. And that when — and that all the options are issued at $40. And that the — when they're exercised, we'll say the stock is $60. Now, at that point, there has been a $10 billion transfer of value. Twenty dollars a share times 500 million shares, a $10 billion transfer of value. Now, the company, when that is done, gets a tax deduction — and at the — for 10 billion — and at the present tax rates, that would result in 3 1/2 billion less tax.

So if you take 20 billion of proceeds from exercise of the options, and you add 3 1/2 billion of tax savings, the Coca-Cola Company receives 23 1/2 billion. And if they should buy in the stock at $60 a share, which it would be selling for then, they would be able to buy 391,666,666 shares. So, in effect, the Coca-Cola Company, net, would be out a little over eight — 108 million shares. And that's on a base of four-billion-four.

So the dilution — assuming all the proceeds from the option exercise and the tax refund were used to buy shares — the dilution would be 108 million shares on 4.4 billion, or about 2 1/2 percent. And I don't like dilution and I don't like 2 1/2 percent dilution. But it's a far cry from the numbers that were getting tossed around. It's a long explanation, but I've never seen the math written about. I mean, I've seen people throwing out claims and all of that.

Cost of Capital

CHARLIE MUNGER: Well, a phrase like "cost of capital," which means different things to different people, and often means silly things to people who teach in business schools, we just don't use it. Warren's definition of behaving in a corporation, so that every dollar retained tends to create more than a dollar of market value for the shareholders, is probably the best way of describing cost of capital. That is not what they mean in business schools.

16. Why Buffett recommends an index fund for his wife's inheritance

In my mailbox, this was the most popular question asked. "Mr. Buffett, you state in your annual letter to shareholders that in your will you have given instructions to the trustee who will be acting for your wife's benefit to put 10 percent of the cash given her in short-term government bonds and 90 percent in a very low-cost S&P 500 index fund. "My question is why are you advising the trustee to put 90 percent of the cash into an S&P 500 index fund instead of into Berkshire shares?"

WARREN BUFFETT: **When I die, incidentally, then all the Berkshire shares I have at that point will go to five different foundations. Every single share. I mean, there are no shares that have not been designated, mentally, to charity. A good many of them have been designated specifically to — in numbers and all that. But — and they will be distributed over the ten years after my estate is closed. So figure over 12 years.**

And I tell my — I tell the trustees that will be holding these shares, you know, "Don't sell any Berkshire shares until they have to be sold." So my views, on Berkshire at least through 12 years after my death are as bullish as anybody could possibly come up with. And incidentally, without those kind of instructions, anybody would say, "You know, you're crazy to keep many, many billions of dollars all in one stock." I can't think of anything better to do it over those 12 years.

In terms of my wife's situation, you know, that is not a question of maximizing capital. It's just a question of total, 100 percent peace of mind on something that cannot get a bad result. And, like I said, there's way more money for her than she'll ever use. As a matter of fact, those of you who know her, you know, may feel that I've added about three zeros too many. But it is not designed for her to get even larger amounts of capital. And there'll be capital, loads of capital left over on that part of it. On the part that I care about maximizing, I have instructed the three trustees to not sell a single share until it has to be sold. So, that's good for 12 years after I die, as to my best advice as to what I want them to hold.

19. Two heads running Berkshire are better than one

"However, has there been any discussion at your board meetings about a replacement for your partner, longtime friend, and co-chairman, Charlie Munger? "Has it been determined Berkshire will continue to be led by a similar dynamic duo? Two magnificent investor minds, each providing a unique point of view, have been a major reason the business has performed magnificently over the decades and has delighted the shareholders."

I do think — I think it's very likely, incidentally, that whoever replaces me as CEO probably has, over the years certainly, developed — they'll never be able to develop another Charlie — but they'll develop somebody that they work with very closely. It's a great way to operate. Berkshire is better off because the two of us have worked together than if either one of us had been working individually, there's no question about that. (Applause) And —but I do think, you know, we saw it with Roberto Goizueta and Don Keough at Coke, we saw it with Tom Murphy and Dan Burke at Cap Cities. I mean, these were magnificent companies. And I think that in both cases that I just named, I think that they accomplished far more because they had two incredible people running them who admired and worked well with the other. And they were complimentary, in terms of the talents they brought. In many ways, it's a great way to operate. You can't will it to somebody.

Cash

We always will have $20 billion around Berkshire. We will never be dependent on the kindness of strangers. It didn't work that well for Blanche DuBois, either. But in any event, the — we don't count on bank lines. You know, we don't count on — we don't count on anything.

There will be some time in the next 100 years, and it may be tomorrow and it may be 100 years from now, and nobody knows, you know, where we cannot depend on anybody else to keep our own strength and to maintain our operations. And we spent too long building Berkshire to have that one moment destroy us. I've always said that, you know, cash is — available cash or credit — is a lot like oxygen: that you don't notice it — the lack of it — 99.9 percent of the time.

But if it's absent, it's the only thing you notice. And we don't want to be in that position. So we will keep 20 billion. We will never go to sleep at night worrying about any event that's taken place that could hurt our ability to keep playing our game. And above 20 billion, we'll try to find ways to invest it intelligently. And so far, we've generally done it. I mean, right — you know, we always had something above that.

Self Driving Cars

Now, when you get to the self-driving car, that is a real threat to the auto insurance industry. I mean, if that proves successful and reduces accidents dramatically, it will be very good for society and it will be very bad for auto insurers.

So you know, that can happen. I don't know how to evaluate over how long a period that might take or what percentage of cars might be affected with that. But it certainly could happen and it would not cause us to be thinking for one second about selling GEICO. Charlie?

CHARLIE MUNGER: Yeah, some of these things happen a lot more slowly than you might think. I went to a program at Harvard, oh, at least 30 years ago, describing how color movies were going come to the house on demand, and they were just around the corner. Well, they've come, but it was 30 years later. I have a feeling that self-driving cars having a huge impact on the market may take quite a while.

Learning about Industries

The — you know, I would go in the investment business. And I would look at lots of companies and I would go and talk to lots of people, and I would try to learn from them what I could about different industries. One thing I did when I was 23, if I got interested in the coal business, I would go out and see the CEOs of eight or ten coal companies. And the interesting thing was I never made appointments usually or anything, I just dropped in. But they —they felt a fellow from Omaha who looked like me couldn't be too harmful.

So they'd always see me. And I would — I'd ask them a lot of questions, but one question I'd always ask them, two questions at the end, I would ask them if they had to put all of their money into any coal company except their own and go away for ten years and couldn't change it, which one would it be and why?

And then I would say, after I got an answer to that, I would say, and if as part of that deal they had to sell short in the equivalent amount of money — in one coal company — which would it be and why? And if I went around and talked to everybody in the coal business about that, I would know more about the coal companies from an economic standpoint than any one of those managers probably would.

So, I think there's lots of ways to learn about business. You're not going learn how to start another Facebook or Google that way, but you can — you can learn a lot about the economic characteristics of companies by reading, personal contact. You do have to have — you have to have a real curiosity about it. I mean, you — I don't think you can do it because your mother's telling you to do it, or something of the sort. (Laughs) I think you — it really has to turn you on. And I mean, what could turn you on more than running around asking questions about coal companies?

But that's what I would do. And I might, in the process of doing that, find some industry that particularly interested me, in my case the insurance industry did, and you might become very well equipped, even perhaps, to start your own insurance company, but perhaps to pick the most logical one to go to work for. If you just keep learning things, something will come along that you'll find extremely useful to do. I mean, it — but you've got to be open to it. Charlie?

CHARLIE MUNGER: Well, you might try a version of the trick that Larry Bird used. When he wanted an agent to negotiate his new contract, he asked every agent why he should be selected. And if he was not going be selected, whom the agent would recommend. And since everybody recommended the same number two choice, Larry Bird just hired him and negotiated the best contract in history.

Buffett: But — the — it's not a bad system to use. You can really learn a lot just by asking. I mean, it's starting to sound a little bit like a Yogi Berra quote or something, but it is — it is literally true that you — if you talk to enough people about something they know something about, and people like to talk. You know, and — here we are talking ourselves.

Customer Focus

CHARLIE MUNGER: Well, GEICO to me is very much like Costco. And one of the reasons it's succeeded is that they really feel a holy duty to have a wonderful product at a very low price. A lot of people talk that game, but very few have it just right down under the body and soul of the company. But GEICO does, and companies like that do tend to grind ahead over time.

CHARLIE MUNGER: Oh, Costco's unbelievable. And it reminds me very much of GEICO, and I'm not surprised that both companies keep taking share. It's easy to talk the game, but living the game is something else. I mean, it's against the human nature of many entrepreneurial people to try and get the price down and the service quality up all the time. I mean, it's like wearing the ultimate hair shirt and yet it works.

IV

WARREN BUFFETT: Yeah, the — actually Graham didn't get too specific about intrinsic value in terms of precise calculations. But intrinsic value has come to be equated with, and I think quite properly, with what you might call private business value.

32. Uber, Airbnb, and the "disruptive" sharing economy

WARREN BUFFETT: Well, they are obviously trying to disrupt some other businesses, and those businesses will fight back in competitive ways, and they may try to fight back through legislation. You know, when anybody's threatened, or any business is threatened, it tries to fight back. If you go back to when State Farm came on the scene in 1921, that the — or '20, or whenever it was, the agency system was sacrosanct, in terms of insurance. It'd been around forever and the big companies were in Hartford or New York and they fought over having the number one agency in town.

So if you came to Omaha and you were at Travelers or Aetna, or whomever it might be, your objective was to get the agent. And the policy holder really wasn't being thought about. And then State Farm came along and they had a better mouse trap, and then GEICO came along with a better mouse trap yet. And so, every — the industries originally — the insurance companies fought back in a lot of ways. But one of the ways they tried to do it was to insist, you know, on various state laws involving what agents could do and what could not be done in insurance without agents and all that. It's — that's standard. And you'll see that, and in the end the better mouse trap usually wins. But the people with the second or third-best mouse trap will try to keep that from happening.

2015

2. Businesses that do best in high inflation

WARREN BUFFETT: Yeah. Well, the best businesses during inflation are usually the best — they're the businesses that you buy once and then you don't have to keep making capital investments subsequently. So you get — you do not face the problem of continuous reinvestment involving greater and greater dollars because of inflation. That's one reason real estate, in general, is good during inflation. If you built your own house 55 years ago like Charlie did, or bought one 55 years ago like I did, it's a one-time outlay, whereas if you're — and you get the — you get an inflationary expansion in replacement capital without having to replace yourself. And if you've got something that's useful to someone else, it tends to be priced in terms of replacement value over time, so you really get the inflationary kick.

Now, if you're in a business such as the utility business or the railroad business, it just keeps eating up more and more money, and your depreciation charges are inadequate and you're kidding yourself as to your real economic profits. So, any business with heavy capital investment tends to be a poor business to be in in inflation and often it's a poor business to be in generally. And the business where you buy something once — a brand is a wonderful thing to own during inflation.

8. Buffett on Adam Smith's "Wealth of Nations"

"So my question is, what did you learn from "The Wealth of Nations" and how did it shape your investment and business philosophy?"

WARREN BUFFETT: Well, it doesn't shape my investment philosophy, but I certainly learned economics from it. And my friend Bill Gates gave me an original copy of it. I was able to study this. Adam Smith wrote it in 1776. It's — you know, there's just — if you read Adam Smith and if you read Keynes, Ricardo, and then — and if you also read that little book we've got out there called "Where Are the Customers' Yachts?" you will have a lot of wisdom.

WARREN BUFFETT: I took an idea of his on the specialization of labor, you know, and he talked about people making pins or something, but I applied that, actually, to philanthropy. You know, I mean, the idea that you let other people do what they're best at and stick with what you're best at, I've carried from mowing my lawn to philanthropy, and it's a wonderful thing to just shove off everything and say somebody else is better than I am at that, and then work in the field that's most productive for you.

2016

Reinsurance

I think their business — the business of the reinsurance companies generally — is less attractive for the next 10 years than it has been for the last 10 years.

In part, that's because what's happened to interest rates. A significant portion of what you earn in insurance comes from investment of the float. And both of those companies, and for that matter almost all of the reinsurance industry, is somewhat more restricted in what they can do with their float, because they don't have this huge capital cushion that Berkshire has, and also because they don't have this great amount of unrelated earning power that Berkshire has. Berkshire has more leeway in what it can do simply because it does have capital that's many times what its competitors have, and it also has earning power coming from a whole variety of unrelated areas — unrelated to insurance. So it was not a negative judgment, in any way, on those two companies. It was not a negative judgment on their managements. But it was a — at least — a mildly negative judgment on the reinsurance business.

Now, we have the ability at Berkshire to actually rearrange, to a degree — we are certainly affected by industry factors — but we have more flexibility in modifying business models, and we've operated that way, over the years, in insurance generally, and particularly in reinsurance. So, a Munich, a Swiss, all the major reinsurance companies, except for us, is pretty well tied to a given type of business model. They don't really have as many options, in terms of where capital gets deployed. They have to continue down the present path. And I think they'll do fine. But I don't think they will do as fine in the next 10 years as they have in the last 10.

Banks

Derivatives are still dangerous, in large quantities, and we have — we would not do them, on a collateralized basis, because if there was a discontinuity, I don't know exactly where we would end up, and I'm never going to get us in a position where we could have money demanded of us and not be able to fulfill it with ease, and with me sleeping well. So I agree with your general caution. I'm not in the least troubled by our Bank of America investment, nor our Wells Fargo — we added to Wells Fargo — and our Bank of America position, right now, is a preferred stock, but we're very likely to exercise the warrants on that. **On the other hand, there are a great number of banks in the world. If you take the 50 largest banks in the world, we wouldn't even think about probably 45 of them.**

Aircraft Leasing

The banks have an advantage over us because their cost of funds is so low now. It's not quite as low as it looks, but I think Wells Fargo, I think the last figure was, you know, down around 10 basis points.

And when somebody has, you know, maybe a trillion dollars or so, and they're paying 10 basis points for it, I don't feel very competitive at Berkshire in that situation. So, pure money-type leasing is not an attractive business for us when we've got other people with a lower cost of funds. I mean, they've got the edge. But you will not see us get in — aircraft leasing doesn't interest me in the least. We've looked at that a lot of times, at various aircraft leasing companies offered to us. And that's a scary business. And some people have done well in it by, in recent years, by using short-term money to finance longer-term assets which have big residual risks, and that just isn't for us.

Buybacks

WARREN BUFFETT: Yeah. Can you imagine somebody going out and saying, we're going to buy a business and we don't care what the price is? You know, we're going to spend $5 billion this year buying a business, we don't care what the price is. But that's what companies do when they don't attach some kind of a metric to what they're doing on their buybacks. To say we're going to buy back 5 billion of stock, maybe they don't want to publicize the metric, but certainly they should say, we're going to buy back 5 billion of stock if it's advantageous to buy it back.

But they don't — you know, if they say we're going buy the XYZ Company, they say, we'll buy it at this price, but we won't buy it at 120 percent of that price. But I have very rarely seen — Jamie Dimon is very explicit about saying he's going to buy back the stock when he's buying it below what he considers intrinsic value to be.

But I have seen hundreds of buyback notices, and I've sat on boards of directors one after another where they have voted buybacks and basically — and they said they were doing it to prevent dilution or something like that. It's got nothing to do with preventing dilution. I mean, if you're — dilution by itself is a negative and buying back your stock at too high a price is another negative. So it has to be related to valuation. And as I say, you will not find a lot of press releases about buybacks that say a word about valuation.

Micro vs. Macro

CHARLIE MUNGER: Microeconomics is what we do, and macroeconomics is what we put up with.

WARREN BUFFETT: But we — Charlie and I are the kind that literally find it interesting in every business — we like to look at micro factors. If we buy — when we buy a See's Candy in 1972, you know, there may have been 140 shops or something. We'll look at the — we'll look at numbers on each one, and we'll watch them over time, and we'll see how third-year shops behave in the second year — we really like understanding businesses.

It's just — it's interesting to us. And some of the information is very useful, and some of it may look like it's not helpful, but who knows when some little fact stored in the back of your mind pops up and really does make a difference. So, we're fortunate in that we're doing what we love doing. I mean, we love doing this like other people like watching baseball games, and which I like to do, too. But they — just the very act, every pitch is interesting, and every movement, you know, and whether the guy's — you know, a double steal is interesting, or whatever it may be, and so that's what our activity is really devoted to, and we talk about that sort of thing.

CHARLIE MUNGER: We try and avoid the worst anchoring effect, which is always your previous conclusion. We really try and destroy our previous ideas.

WARREN BUFFETT: Charlie says that if you disagree with somebody, you want to be able to state their case better than they can.

WARREN BUFFETT: And at that point, you've earned the right to disagree with them.

CHARLIE MUNGER: Otherwise, you should just keep quiet.

10. Berkshire's cash flow outlook

CLIFF GALLANT: One of the great financial characteristics of Berkshire today is its awesome cash flow. While its simple earnings-less-capex formula yields an annual free cash flow calculation of, I figure, of around 10 to 12 billion, in reality it seems to be much higher, closer to 20 billion, and I think, in part, due to changes in the deferred tax asset year-to-year. What is the outlook for free cash flow, and can investors continue to expect similar dynamics going forward?

WARREN BUFFETT: Yeah. There's a lot of deferred tax that's attributable to unrealized appreciation in securities. I don't have the figure, but let's just assume that's 60 billion of unrealized appreciation in securities. Well, then there would be 21 billion of deferred tax. That isn't really cash that's available. It's just an absence of cash that's going to be paid out until we sell the securities.

Some arises through bonus depreciation. The railroad will have depreciation for tax purposes that's a fair amount higher than for book purposes. But overall, I think of, primarily, the cash flow of Berkshire as a practical matter relating to our net income plus our increase in float, assuming we have an increase. And over the years, float has added $80-billion-plus to make available for investment beyond what our earnings have allowed for, and that's the huge element. We're going to spend more than our depreciation in our businesses, primarily, number one, because of the — well, the railroad and Berkshire Hathaway Energy are two entities that will spend quite a bit more than depreciation, in all likelihood, for a long, long, long, long time. And the other businesses, unless we get into inflationary conditions, it won't be a huge swing one way or the other.

So, our earnings, the 17 — not counting investment, not counting capital gains — but our earnings, which were — whatever they were, you know, around 17 billion — plus our change in float is the net new available cash. But, of course, we can always sell securities and create additional cash. We can borrow money and create additional cash. But it's not a very complicated economic equation at Berkshire. People didn't — for a long time, they didn't appreciate the value of float. We kept explaining it to them, and I think they probably do now. The big thing, the goal, what Charlie and I think about, we want to add, every year, something to the normalized — you know, the normalized earning power per share of the company.

12. Due diligence doesn't find the real risks of buying a company

It's interesting. We've made plenty of mistakes in acquisitions. Plenty. And we made mistakes in not making acquisitions, but the mistakes are always about making an improper assessment of the economic conditions in the future of the industry of the company. They're not a bad lease. They're not a specific labor contract. They're not a questionable patent. They're not the things that are on the checklist, you know, for every acquisition by every major corporation in America. Those are not the things that count. What counts is whether you're wrong about — whether you've really got a fix on the basic economics and how the industry's likely to develop, or whether Amazon's likely to kill them, you know, in a few years, or that sort of thing.

We have not found a due diligence list that gets at what we think are the real risks when we buy a business. It isn't — it just isn't the things that are on the checklist that really count. Assessing whether a manager, who I'm going to hand a billion dollars to, for his business, and he is going to hand me a stock certificate, assessing whether he's going to behave differently in the future in running that business than he has in the past when he owned it, that's incredibly important, but there's no checklist in the world that's going to answer that.

So, if we thought there were items of due diligence — and incidentally, there are a few that get covered. I mean, you want to make sure that they don't have twice as many shares out as you're buying or something of the sort. But they're — if we thought there were things that we were missing that were of importance in assessing the future economic prospects of the business, you know, we would, by all means, drill down on those.

But the question of — you know, when we bought See's, it probably had 150 leases. You know, when we — when we buy Precision Castparts, they have 170 plants, you know, there's going to be pollution problems at some place. Those are — that is not what determines whether a $32 billion acquisition is going to look good five years from now, or ten years from now. We try to focus on those things.

CHARLIE MUNGER: How many people who, in this room, are happily married, carefully checked their spouse's birth certificate and so on? My guess is that our methods are not so uncommon as they appear.

17. "Very cheap money makes me pay a little more"

When interest rates go from zero to negative in a country, how does that change the way that you value a company or a stock?

WARREN BUFFETT: Well, going from — which we haven't done in this country, yet — but going from zero to minus-a-half is really no different than going from 4 to 3 and a half. It has a different feel to it, obviously, if you have to pay a half a point to somebody. But if you have your yield — or your base rate — reduced by a half a point, it's of some significance, but it isn't dramatic.

What's dramatic is interest rates being where they are, generally. I mean, whether they're zero, plus a quarter, minus a quarter, plus a half, minus a half, we are dealing with a situation of, essentially, very close to zero interest rates, and we have been for a long time and longer than I would've anticipated. The nature of it is that you'll pay more for a business when interest rates are zero than if they were, like, 15 percent when [former Federal Reserve Chairman Paul] Volcker was around, and you can take that up and down the line.

I mean, we don't get too exact about it, because it isn't that exact a science, but very cheap money makes me pay a little more for businesses than when money was at what we previously thought was normal rates. And very tight money would cause me to pay somewhat less. And if you ask me whether I paid a little more for Precision Castparts because interest rates were around zero, than if they'd been 6 percent, the answer is yes. I try not to pay too much more, but it has an effect. And if interest rates continue at this rate for a long time, if people ever really start thinking something close to this is normal, that will have an enormous effect on asset values.

19. American Express faces tough competition

Shouldn't a prudent investor — shouldn't Berkshire — periodically reassess its reasons for owning an investment?

WARREN BUFFETT: Well, we reassess our reasons for owning all investments on almost a continuous basis. And I personally feel OK about American Express. We — and I'm happy to own it. I think — but their position — and it has been under attack for decades, more intensively later — lately — and it will continue to be under attack. I mean, it's too big a business, and it's too interesting a business, and it could be too attractive a business, for people to ignore it.

CHARLIE MUNGER: A lot of great businesses aren't quite so great as they used to be. The packaged good business, the Procter & Gambles and so forth of the world — General Mills — they're all weaker than they used to be at their peak and —

WARREN BUFFETT: And the auto companies. I mean when Charlie and I were —

CHARLIE MUNGER: Oh, my God. When I think of the power of General Motors when I was young, and what happened — they wiped out all the shareholders — I would no more have predicted that. When I was young, General Motors loomed over the economy like a colossus. It looked totally invincible. Torrents of cash. Torrents of everything.

WARREN BUFFETT: Trying to hold down market share.

CHARLIE MUNGER: Yes, because they — yeah, they were afraid they'd be too monopolistic. And so the world changes, and we can't change — make a portfolio change — every time something is a little less advantaged than it used to be.

CHARLIE MUNGER: I think anybody in payments, probably has — with an established long-time player with an old method — has more danger than used to exist. It's just — there's more fluidity in it.

22. BNSF's capital expenditures

WARREN BUFFETT: As I mentioned in the annual report, in the case of all railroads, merely spending their depreciation expense will not keep them in the same place. So depreciation is an inadequate measure of the actual steady state of capital expenditure needs of a railroad, even in these fairly noninflationary ways. And that's an important consideration in buying the business. We knew that going in, and it's been reinforced since.

We spent a lot of money in 2015 because we had a lot of problems to correct. That was when we spent the 5.7 billion. I would say that the true maintenance capex, if you're looking at 4.3 billion, is higher than 60 percent of that number, when you really evaluate keeping the railroad in competitive shape to do just the same volume as it would be doing the year before. We've also had something called "positive train control," which amounts to a lot of money for the industry. I think we may be a little further along than most of them in paying for that, but that's 2 or $300 million a year and maybe — I don't know whether it'd be close to 2 billion, or something like that, in aggregate.

So it is a very capital-intensive business. We run — at the BNSF — we run far more gross, in revenue ton miles, than any other railroad in North America. And that has obviously some — is a factor on capital expenditures. But I would say that it's very likely that we will spend more than depreciation — unfortunately, quite a bit more than depreciation — to stay in the same place for a long, long time, as will other railroads.

2017

Apple

And Apple — I regard them as being in quite different businesses. I think Apple is much more of a consumer products business, in terms of the — in terms of sort of analyzing moats around it, and consumer behavior, and all that sort of thing. It's obviously a product with all kinds of tech built into it. But in terms of laying out what their prospective customers will do in the future, as opposed to, say, IBM's customers, it's a different sort of analysis.

CHARLIE MUNGER: **Well, we avoided the tech stocks, because we felt we had no advantage there and other people did. And I think that's a good idea not to play where the other people are better. But, you know, if you ask me, in retrospect, what was our worst mistake in the tech field, I think we were smart enough to figure out Google. Those ads worked so much better in the early days than anything else. So I would say that we failed you there. And we were smart enough to do it and didn't do it. We do that all the time, too.**

Amazon

It's harder to predict, in my view, the winners in various items, or how much price competition will enter in to something like cloud services and all of that. I will — I made a statement the other day, which it's really remarkable, and I was — I asked Charlie whether he could think of a situation like it — where one person has built an extraordinary economic machine in two really pretty different industries, you know, almost simultaneously, as has happened —

CHARLIE MUNGER: From a standing start at zero.

WARREN BUFFETT: From a standing start at zero, with other — with competitors with lots of capital and everything else. To do it in retailing and to do it with the cloud, like Jeff Bezos has done, I mean, I — People like the Mellons invested in a lot of different industries and all of that. But he has been, in effect, the CEO, simultaneously, of two businesses starting from scratch that if — you know, Andy Grove used to use — at Intel — used to say, you know, "Think about if you had a silver bullet and you could shoot it at — and get rid of one of your competitors, who would it be?" Well, I think that both in the cloud and in retail, there are a lot of people that would aim that silver bullet at Jeff.

And he's done — it's a different sort of game — but he's, you know, at The Washington Post, he's played that hand as well as anybody I think possibly could. So it's a remarkable business achievement, where he's been involved, actually, in the execution, not just bankrolling it, of two businesses that are probably as feared by their competitors, almost, as any you can find.

Airline Industry

And I will tell you that if capacity — you know, it's a fiercely competitive industry. The question is whether it's a suicidally competitive industry, which it used to be.

I mean, when you get virtually every one of the major carriers, and dozens and dozens and dozens of minor carriers going bankrupt, you know, it ought to come upon you, finally, that maybe you're in the wrong industry. It has been operating for some time now at 80 percent or better of capacity — being available seat miles — and you can see what deliveries are going to be and that sort of thing. So if you make — I think it's fair to say that they will operate at higher degrees of capacity over the next five or 10 years than the historical rates, which caused all of them to go broke. Now the question is whether, even when they're doing it in the 80s, they will do suicidal things in terms of pricing, remains to be seen.

They actually, at present, are earning quite high returns on invested capital. I think higher than either FedEx or UPS, if you actually check that out. But that doesn't mean — tomorrow morning, you know, if you're running one of those airlines and the other guy cuts his prices, you cut your prices, and as you say, there's more flexibility when fuel goes down to bring down prices than there is to raise prices when prices go up. So the industry, you know — it is no cinch that the industry will have some more pricing sensibility in the next 10 years than they had in the last hundred years. But the conditions have improved for that. They've got more labor stability than they had before, because they're basically all going to — they've been through bankruptcy. And they're all going to sort of have an industry pattern bargaining, it looks to me like. They're going to have a shortage of pilots to some degree. But it's not like buying See's Candy. Charlie?

CHARLIE MUNGER: **No, but the investment world has gotten tougher with more competition, more affluence, and more absolute obsession with finance throughout the whole country. And we picked up a lot of low-hanging fruit in the old days, where it was very, very easy. And we had huge margins of safety. Now we operate with a less advantageous general climate. And maybe we have small statistical advantages, where in the old days it was like shooting fish in a barrel.**

WARREN BUFFETT: **Gregg, the — I don't — I think the odds are very high that there are more revenue passenger miles five years from now or 10 years from now. If the airlines — if the airline companies are only worth, five or 10 years from now, what they're worth now, in terms of equity, we'll get a pretty reasonable rate of return, because they're going to buy in a lot of stock at fairly low multiples. So if the company's worth the same amount at the end of the year and there's fewer shares of stock outstanding, over time we make decent money.** And all four of the major airlines are buying in stock at a —

CHARLIE MUNGER: You've got to remember that the railroads were a terrible business for decades and decades and decades and then they got good.

WARREN BUFFETT: Yeah, it — we like — I like the position. **Obviously, by buying all four, it means that it's very hard to distinguish who will do the — at least in my mind — it's hard to distinguish who will do the best. I do think the odds are quite high that, if you take revenue passenger miles flown five or 10 years from now, it will be a higher number. And that will be — There'll be low-cost people who come in. And, you know, the Spirits of the world and JetBlues, whatever it may be. But the — my guess is that all four of the companies we have will have higher revenues. The question is what their operating ratio is. They will have fewer shares outstanding by a significant margin. So even if they're worth just what they're worth today, we could make a fair amount of money. But it is no cinch, by a long shot.**

At what rate can Berkshire IV Grow

So the question is, "At what rate has Berkshire compounded intrinsic value over the last 10 years? And at what rate, including your explanation for it please, do you think intrinsic value can be compounded over the next 10 years?"

WARREN BUFFETT: Yeah. Intrinsic value, you know, can only be calculated — or gains — you know, in retrospect. But the intrinsic value pure definition would be the cash to be generated between now and Judgment Day, discounted at an interest rate that seems appropriate at the time. And that's varied enormously over a 30 or 40-year period. **If you pick out 10 years, and you're back to May of 2007, you know, we had some unpleasant things coming up. But we've — I would say that we've probably compounded it at about 10 percent.**

And I think that's going to be tough to achieve, in fact almost impossible to achieve, if we continued in this interest rate environment. That's the number one — if you asked me to give the answer to the question, if I could only pick one statistic to ask you about the future before I gave the answer, I would not ask you about GDP growth. I would not ask you about who was going to be president. I would — a million things **— I would ask you what the interest rate is going to be over the next 20 years on average, the 10-year or whatever you wanted to do. And if you assume our present interest rate structure is likely to be the average over 10 or 20 years, then I would say it'd be very difficult to get to 10 percent.**

On the other hand, if I were to pick with a whole range of probabilities on interest rates, I would say that that rate might be — it might be somewhat aspirational. And it might well — it might be doable. And if you would say, "Well, we can't continue these interest rates for a long time," I would ask you to look at Japan, you know, where 25 years ago, we couldn't see how their interest rates could be sustained. And we're still looking at the same thing. So I do not think it's easy to predict the course of interest rates at all. And unfortunately, predicting that is embedded in giving a good answer to you.

I would say the chances of getting a terrible result in Berkshire are probably as low as about anything you can find. Chance of getting a sensational result are also about as low as anything you can find. So if I — I would — I — **My best guess would be in the 10 percent range, but that assumes somewhat higher interest rates — not dramatically higher — but somewhat higher interest rates in the next 10 or 20 years than we've experienced in the last seven years.**

Better Returns if a Crisis Occurs

CHARLIE MUNGER: **Well, I think it's true that we're peculiar in one way. If things go to hell in a handbasket and then get better later, we're likely to do better than most others. And we don't wish for that.** And we don't want our company to have to suffer through it. And we fear what might happen if the country went through the ringer like that. But if that real adversity comes, we're likely to do better in the end. We're good at navigating through that kind of stuff.

23. Big change: You don't need money to run America's biggest companies

WARREN BUFFETT: Well, we'd love to find them. I mean, there's no question that buying a highreturn- on-assets, very light-capital-intensive business that's going to grow beats the hell out of buying something that requires a lot of capital to grow.

And this varies from day to day, but I believe — and I don't think it's sufficiently appreciated. I believe that probably the five largest American companies by market cap — and some days we're in that group and some days we aren't — let's assume we're not in that group on a given day — they have a market value of over $2 1/2 trillion, and that 2 1/2 trillion is a big number. I don't know whether the aggregate market cap of the U.S. market is, but that's probably getting up close to 10 percent of the whole market cap of the United States. And if you take those five companies, essentially, you could run them with no equity capital at all. None. That is a very different world than when Andrew Carnegie was building a steel mill and then using the earnings to build another steel mill and getting very rich in the process, or Rockefeller was building refineries and buying tank cars and everything. Generally speaking, over — for a very long time in our capitalism, growing and earning large amounts of money required considerable reinvestment of capital and large amounts of equity capital, the railroads being a good example.

That world has really changed, and I don't think people quite appreciate the difference. You literally don't need any money to run the five companies that are worth collectively more than $2 1/2 trillion, and who have outpaced any number of those names that were familiar, if you looked at the Fortune 500 list 30 or 40 years ago, you know, whether it was Exxon or General Motors or you name it. So we would love — I mean, there's no question that a business that doesn't take any capital and grows and has, you know, almost infinite returns on required equity capital, is the ideal business.

And we own a couple of businesses — a few businesses — that earn extraordinary returns on capital, but they don't grow. We still love them, but if they had — if they were in fields that would grow, believe me, we wouldn't — you know, they would be number one on our list. We aren't seeing those that we can buy and that we understand well. But you are absolutely right that that's a far, far, far better way of laying out money than what we're able to do when buying capital-intensive businesses. Charlie?

CHARLIE MUNGER: Yeah. The chemical companies of America, at one time, were wonderful investments. Dow and DuPont sold at 20-some times earnings, and they kept building more and more complicated plants and hiring more Ph.D. chemists, and it looked like they owned the world. Now, most chemical products are sort of commoditized and it's a tough business being a big chemical producer. And in comes all these other people like Apple and Google and they're just on top of the world. I think the questioner's basically right that the world has changed a lot, and that the people who have made the right decisions in getting into these new businesses that are so different from the old ones have done very well.

WARREN BUFFETT: Yeah, Andrew Mellon would be absolutely baffled by looking at the high-cap companies now. I mean, the idea that you could create hundreds of billions of value essentially without assets — without tangible assets —

WARREN BUFFETT: Fast, yeah. But that is the world. I mean, there is — When Google can sell you something that — where GEICO was paying 11 bucks or something every time somebody clicked something — that is a lot different than spending years finding the right site and developing, you know, iron mines to supply the steel plants and, you know, railroads to haul the iron to where the steel is produced and distribution points, and all that sort of thing.

Our world was built — you know, when we first looked at it, our U.S. — our capitalist system, basically, was built on tangible assets, and reinvestment, and all that sort of thing, and a lot of innovation and invention to go with it. But this is so much better, if you happen to be good at it, to essentially be able to build hundreds of billions of market value without really needing any capital. That is a different world than existed in the past. And I think, listen, I think it's a world that is likely to continue. I mean, the trend is, I don't think the trend in that direction is over by a long shot.

CHARLIE MUNGER: A lot of the people who are chasing that sort of thing very hard now in the venture capital field are losing a lot of money. It's a wonderful field, but not everybody's going to win big in it. A few are going to win big in it.

34. Most financial advisors don't deserve their fees

And if you go to a dentist, if you hire a plumber, in all of the professions, there is value added by the professionals as a group, compared to doing it yourself or just randomly picking laymen. In the investment world, it isn't true. I mean, they, the active group, the people that are professionals, in aggregate, are not, cannot do better than the aggregate of the people who just sit tight.

Waiting for Opportunity

WARREN BUFFETT: Yeah. So, it — you know, we don't like that. And we shouldn't use your money that way for a long period of time. And, then, the question is, you know, are we going to be able to deploy it? And I would say that history is on our side, but it'd be more fun if the phone would ring instead of just relying on history books. And, you know, I am sure that sometime in the next 10 years — and it could be next week or it could be nine years from now — there will be markets in which we can do intelligent things on a big scale.

But it would be no fun if that happens to be nine years off. And I don't think it will be, but just based on how humans behave and how governments behave and how the world behaves. But like I say, at a point, the burden of proof really shifts to us, big-time. And there's no way I can come back here three years from now and tell you that we hold 150 billion or so in cash or more, and we think we're doing something brilliant by doing it.

13. Artificial intelligence impact is hard to predict

Let's assume one person could push a button and, essentially, through various machines and robotics, all kinds of things, turn out all of the output we have in this country. So, everybody's — there's just as much output as we have. It's all being done by, you know, instead of 150-some million people being employed, one person. You know, is the world better off or not? Well, certainly we'd work a lot less hours a week — of work per week and so on.

I mean, it would be a good thing, but it would require enormous transformation in how people relate to each other, what they expect of government, you know, all kinds of things. And, of course, as a practical matter, more than one person would keep working. But pushing the idea that way is one of the — you'd certainly think that's one of the consequences of making great progress in artificial intelligence. And that's enormously prosocial, eventually. It's enormously disruptive in other ways. And it can have huge problems, in terms of a democracy and how it reacts to that.

WARREN BUFFETT: How about if we got twice as productive in a short period of time, so that 75 million people could do what 150 million people are doing now?

CHARLIE MUNGER: I think you'd be amazed how quickly people would react to that.

CHARLIE MUNGER: Don't think you have to worry — I don't think you have to worry about coming out at 25 percent a year. You know, I think you have to worry about it — you're going to get less than two percent a year. That's what's worrisome.

WARREN BUFFETT: OK. We'll move on. But it will be, you know, it's an absolutely fascinating subject to see what happens with this. But it's very, very hard to predict. If — in some way, you know, we've got 36,000 people, say, employed at GEICO, you know. And if you could do the same — perform all the same functions, virtually all the same functions even, and do it with five- or 10,000 people, and it came on quickly, and the same thing was happening in a great many other areas, you know, I don't think we've ever experienced anything quite like that. And maybe we won't experience anything like it in the future.

15. I "underestimated the brilliance" of Jeff Bezos at Amazon

What is your current outlook and — on Amazon? And why hasn't Berkshire bought in?

WARREN BUFFETT: **Well, because I was too dumb to realize what was going to happen — (laughs) — even though I admired Jeff. I've admired him for a long, long time and watched what he was doing. But I did not think that he could succeed on the scale he has. And I certainly didn't — I didn't even think about the possibility of doing anything with Amazon Web Services or the cloud. So if you'd asked me the chances that, while he was building up the retail operation, that he would also be doing something that was disrupting the tech industry, you know, that would've been a very, very long shot for me. And I've underestimated — I've really underestimated the brilliance of the execution.**

I mean, it's one thing to dream about doing this stuff online, but it takes a lot of ability. And, you know, you can read his 1997 annual report. And he laid out a roadmap. And he's done it, and done it in spades. **And if you haven't seen his interview on Charlie Rose three or four months ago — CharlieRose.com — go to it and listen to it because you'll learn a lot. At least, I did. So, I just plain — It always looked expensive. And I really never thought that he would be where he is today.** I thought he would do — I thought he was really brilliant. But I did not think he would be where he is today when I looked at it three, five, eight, 12 years ago — whenever it may have been. Charlie, how did you miss it? (Laughter)

CHARLIE MUNGER: It was easy. What was done there was very difficult, and it was not at all obvious that it was all going to work as well as it did. **I don't feel any regret about missing out on the achievements of Amazon. But other things were easier. And I think we screwed up a little. Well, I meant Google.**

18. "Valuation … is not reducible to any formula"

My question for you is, are market cap to GDP and cyclically adjusted P/E still valid ways to consider market valuation? And how do those influence Berkshire's investment decisions?

WARREN BUFFETT: **People are always looking for a formula. And there is an ultimate formula, but the trouble is you don't know what to stick in for the variables. And, you know, that's the value of anything, being the present value of all the cash it's ever going to distribute. But the P/E ratios — I mean, every number has some degree of meaning, means more sometimes than others. Valuation of a business is — it's not reducible to any formula where you can actually put in the variables perfectly.** And both of the things that you mentioned get — themselves, get bandied around a lot. It's not that they're unimportant. But sometimes they're — they can be very important. Sometimes they can be almost totally unimportant. It's just not quite as simple as having one or two formulas and, then, saying the market is undervalued or overvalued or a company is undervalued or overvalued.

The most important thing is future interest rates. And, you know, and people frequently plug in the current interest rate saying that's the best they can do. After all, it does reflect a market's judgment. And, you know, the 30-year bond should tell you what people who are willing to put out money for 30 years and have no risk of dollar gain or dollar loss at the end of the 30-year period. But what better figure can you come up with? I'm not sure I can come up with a better figure. But that doesn't mean I want use the current figure, either. So, I would say that — I think

Charlie's answer will be that he does not come up with China versus the U.S. market based on what you've mentioned as yardsticks. But, no, Charlie, you tell them.

CHARLIE MUNGER: All I meant was that — I said before that the first rule of fishing is to fish where the fish are — is that a good fisherman can find more fish in China if your — if fish is the stock market. That's all I meant.

23. "We're getting too much medicine"

CHARLIE MUNGER: This is Redding. This is one of my favorite stories. There are a bunch of very ambitious cardiologist and heart surgeons in Redding. And they got the thought that, really, what a heart was was a "widowmaker." So everybody — every patient that came in, they said, "You've got a widowmaker in your chest. And we know how to fix it." And so they recommended heart surgery for everybody.

And, of course, they developed a huge volume of heart surgery. And they got very wonderful results because nobody comes through heart surgery better than the man who doesn't need it at all. (Laughter) **And they made so much money that the hospital chain, which was Tenet, brought all its other hospitals — why can't you be more like Redding? And this is a true story. And it went on and on and on.** And finally, there was some beloved Catholic priest. And they said, "You've got a widowmaker in your chest." And he didn't believe them. And he blew the whistle.

CHARLIE MUNGER: At any rate — well, when you get a routine, you just keep using it, you know. A heart is a widowmaker. It's a widowmaker. Later, I met one of the doctors who threw these people out of the medical profession. And I said to him, "In the end, did they think they were doing anything wrong?" He said, "No, Charlie. They thought that what they were doing was good for people." That is why it's so hard to fix these things. The self — the delusion that comes into people as they make money and get more successful by doing God-awful things should never be underestimated. And it's — there's a lot — (Applause) But the heart surgery rate was 20 times normal or something. You'd think you'd notice if you're running a hospital. And — but they did notice. They wanted the other hospitals to be more like it.

27. "Don't wait till you're 93"

And I got some advice for the young. If you got anything you really want to do, don't wait till you're 93.

2018

21. Munger is more interested than Buffett in Chinese stocks

So my question is, if you only have $1 billion in your portfolio today, how would you change your investments? Would you consider more investment opportunities in emerging markets such as China? Thank you.

WARREN BUFFETT: Yeah. I would say, if I were working with a billion, I would probably find - within a $30 trillion market in the United States, where I understood things better, generally, than I do around the world - I'd probably find opportunities there that would be better, incidentally, by some margin, than what we can find for hundreds of billions. But I wouldn't - there's no way I'd rule out emerging markets. There was a time, 15 years ago or so, when just because it was kind of interesting and it took me back to my youth, I - on the weekend, I went through a directory of Korean stocks. And I bought - and these were small stocks - well, they weren't small by standards of either Korean or American business. They were big, big companies.

But I found 15 or 20 in - that were statistically cheap and bought some of each one myself. And there are opportunities with smaller amounts of money to do things that we just can't do. And - but I - my first inclination always would be to comb through things in the United States. And - But I've combed through - in other countries. I probably wouldn't get into very, very small markets because there can be a lot of difficulties even in market execution and taxation, (inaudible).

You can find - if you can't find it, you know, in America and China and Britain and a few other places - (laughs) - you probably aren't going to find it someplace else. You may think you've found it. But that may be - it may be a different game than you know. Our problem is size, not geography.

CHARLIE MUNGER: Well, I already have more stocks in China than you do, as a percentage, so I'm with the young lady.

17. Cash needed to support Berkshire insurance operations

My question relates to the Berkshire insurance operations. When I look at the quarterly billing sheets of the last two decades, I noticed a pattern that I kindly ask you to discuss. The sum of cash plus fixed income always hovers around 100 percent of the amount of insurance float. Therefore, my question is, is it fair to say that from the 128 billion of consolidated cash plus fixed income as of March, 116 billion are actually needed to support the insurance operations?

WARREN BUFFETT: No, I appreciate — **The answer is no. But he deserves an explanation of how this — maybe I haven't looked at it the way he's looked at it. We would much rather have a number closer to 20 than to have 116. And we do not correlate or, in effect, measure the float and then decide how much to put or leave in cash, in fixed income. The fact —our float keeps growing. And lately our — which is by design and has been terrific for us — and our cash and cash equivalents have has grown because the competition for acquisitions has become much stronger as — both as money has piled up with the buyers of businesses and because debt has been so cheap and a variety of factors.**

But I don't think those are necessarily permanent. In fact, it would be reasonably true they aren't permanent. It's just a question of when they change. **We are not tying, as Charlie said, we're not tying the cash and cash equivalents at all to float.** The float is (inaudible). The float went up $2 billion in the first quarter. And there is no way that that that float can shrink a lot in any short period. It just structurally has been set up in such a way that it will not — it cannot shrink. And actually, I think it'll grow a little bit for a while.

18. "Amazing" earnings in the new "asset-light economy"

CAROL LOOMIS: In your 1999 article in Fortune magazine, you stated your belief that after-tax corporate profits were unlikely to hold much above 6 percent for any sustained period, due not only to competition but also to public policy. You stated in the article, "If corporate investors, in aggregate, are going to eat an ever-growing portion of the economic pie, some other group will have to settle for a smaller portion. That would justifiably raise political problems." Since 2008, after-tax corporate profits have been 8 to 10 percent of GDP. Do you believe that is a permanent shift in the U.S. economy? And of course, we have to think about the latest tax bill. Or will corporate profits revert back to the 4 percent to 6 percent of GDP range that was normal in the 20th century?

WARREN BUFFETT: **Well, it's been an interesting development during that period. It goes back a little bit before that period. But you now have the four largest companies, by market value, in the United States — a $30 trillion market — you have four companies that essentially don't need any net tangible assets. And if you go back many years, I mean, if you looked to the largest companies — Carol used to put out the Fortune 500 list. And you know, it would be AT&T and General Motors, and it was companies that — Exxon Mobil — it was companies that just required lots of capital in order to produce earnings.**

So American industry has gotten incredibly more profitable, in aggregate, in the last 20 or 30 years. You look at the return on the S&P 500, the earnings as a percent of net tangible assets, and the rest is just, you know, if you buy a company that has a million dollars' worth of net worth and you pay a billion for it, it still only had the million dollars' of net worth. I mean you just paid more for it. So the basic profitability of the company is huge, even though your investment may be at a significantly higher price.

So that what has happened is that, I think if you look at the earnings on tangible net worth of the S&P 500 and compare it to 20 years ago, it is amazing. And that is really due to the fact that this has become somewhat, you could call it an asset-light economy. And you know, those four companies that earn 10 percent of the — they comprise close to 10 percent of the market value of the entire publicly-traded corporate America, they don't — and they don't take any money, basically. And that is a changing world. And they will earn even more money with the tax rate going down. And I don't think people have quite processed all that information in terms of what has gone on in the market.

You don't — you know, [Andrew] Carnegie built a steel mill, and then he paid it off. Or he borrowed a little money, and then he built another steel mill, and all of that sort of thing. But it was enormously capital-intensive. And one industry after another. AT&T was enormously capital-intensive. And now the money is in the asset-light — I mean, huge money is in the — not only asset-light business — but the negative asset. You know, IBM even, you know, had — it has no tangible — it has a net — minus tangible net worth. There's nothing wrong with that. It's terrific. But it is not the world we lived in 30 years ago.

And in that sense, I didn't see that coming in 1999 when I wrote whatever I wrote there. It hasn't changed the profitability of the asset-heavy companies particularly. I mean, it isn't like oil. If you take the five most capital-intensive industries in the '90s, I don't think you'll find that their earnings on tangible asset have increased a lot. But you will find that this group has moved in that really doesn't — they don't need any net tangible assets at all, or they need very minor amounts.

CHARLIE MUNGER: There's also a lot of financial engineering that's raised leverage, even in the capital-intense businesses. And you know, while Warren may have predicted a little wrong when he wrote that very scholarly article, he didn't invest wrong. And so it just shows that it's hard to make these economic predictions.

Scuttlebutt

WARREN BUFFETT: We want to see a lot of — if we're talking about a consumer product — we want to see how a consumer product behaves under a lot of different circumstances, and then we want to use something — actually, there was a book by Phil Fisher written around 1960 called "Common Stocks and Uncommon Profits." It's one of the great books on investing. And it talks about the "scuttlebutt method" of investing, which was quite a ways from what Ben Graham taught me in terms of figures. But it's a very, very good book. And you can learn a lot, you know, just by going out and using some shoe leather.

Now they call them channel checks now or something like that. But it's — you can get a feel for some products, and then there are others you can't. And then sometimes you're wrong. But it is a good technique. It's an important investing technique, I would say that. And Ted [Weschler] and Todd [Combs] do a lot of that. And they have people — some people that help them out on doing it, too. Charlie's done it with Costco. I mean, he's — (Laughs)

I mean, all the time he is finding new virtues in Costco, you know, and then it — and he's right, incidentally. I mean, Costco has an enormous appeal to its constituency. They delight — they surprise and delight their customers. And there is nothing like that in business. You have delighted customers, you're a long way home.

Ben Graham

CHARLIE MUNGER: **But the world changed. Before he died, Bill Graham — I mean, Ben Graham — recognized that the exact way he sought undervalued companies wouldn't necessarily work for all times under all conditions. And that's certainly the way it worked for us.** We gradually morphed into trying to buy the better companies when they were underpriced, instead of the lousy companies when they were underpriced. And of course, that worked pretty well for us.

And Ben Graham, he outlived the game that he played personally most of the time. He lived to see most of it fade away. I mean, just to find some company that's selling for one third of its working capital, and figure out it could easily be liquidated and distribute $3 for every dollar of market price. Lots of luck if you can find those in the present market. And if you can find them, they're so small that Berkshire wouldn't find them of any use anyway.

So we've had to learn a different game. And that's a lesson for all the young people in the room. If you're going to live a long time, you have to keep learning.

CHARLIE MUNGER: What you formerly knew is never enough. So if you don't learn to constantly revise your earlier conclusions and get better (inaudible), you are — I always use the same metaphor. You're like a one-legged man in an ass-kicking contest. (Laughter)

WARREN BUFFETT: Graham, incidentally, one point, important point. Graham was not scalable. I mean, you could not do with really big money. And when I worked for Graham-Newman Corp, here he was, the dean of all analysts. And you know, he was an intellect above all others around that time. But our — the investment fund was $6 million, and the partnership that worked in tandem with the investment company also had about $6 million in it. So we had 12 million bucks we were working with. Now, you can make adjustments for inflation and everything. But it was just a tiny amount. It wasn't really scalable. And the truth is that Graham didn't care, because he really wasn't interested in making a lot of money for himself. So he had no reason to want to find something that could go on and on, become larger and larger.

And so the utility of chapter eight, in terms of looking at stocks as a business, is of enormous value. The utility of chapter 20 about a margin of safety is of enormous value. But that's not complicated stuff.

CHARLIE MUNGER: I finally figured out why the teachers of corporate finance often teach a lot of stuff that's wrong. When I had some eye troubles very early in life, I consulted a very famous eye doctor. And I realized that his place of business was doing a totally obsolete cataract operation. They were still cutting with a knife after better procedures had been invented. I said, "Why are you in a great medical school performing absolute obsolete operations?" And he said, "Charlie, it's such a wonderful operation to teach." (Laughter) Well, that's what happens in corporate finance. They get these formulas, and it's a fine teaching experience. (Laughter) You give them a formula, you present the problem, they use the formula. You get a real feeling of worthwhile activity. (Laughter) There's only one there. It's all balderdash.

WARREN BUFFETT: Yeah, whenever you hear a theory described as elegant, watch out, you know.

28. "What Jeff Bezos has done is something close to a miracle"

But I'm wondering about your interests in not just Apple, but all of the tech stocks, like Amazon and Google. Because you've avoided them, you've stated in the past, because they're complicated, you should stick with something you understand. On the other hand, Amazon and Google have what you call a very durable competitive advantage. They really hardly have any competitor. And that's true in China, too, of Alibaba and Tencent. So it seems like it's a conflict, and I'm wondering if you're going to be turning the corner and going into these tech companies that seem to have no serious competition.

WARREN BUFFETT: Well, we certainly looked at them. And we don't think of whether we should be in tech companies or not, or that sort of thing. We are looking for things when we do get into the durability of the competitive advantage, and whether we think that our opinion might be better than other people's opinion in assessing the probability of the durability, so to speak. **But the truth is that I've watched Amazon from the start, and I think what Jeff Bezos has done is something close to a miracle. And the problem is, if I think something will be a miracle, I tend not to bet on it.** (Laughs)

It would have been better — far better, obviously — if we — if I had some insights into certain businesses. But you know, in fact, Bill told me early on — Bill Gates told me early on — you know, that I think I was on AltaVista and he suggested I turn to Google. But the trouble is I saw that Google was skipping past AltaVista, and then I wondered if anybody could skip past Google. And I saw at GEICO that we were paying a lot of money for something that cost them nothing incrementally. We've looked at it, and you know, I made a mistake in not being able to come to a conclusion where I really felt that at the present prices that the prospects were far better than the prices indicated.

And I didn't go into Apple because it was a tech stock in the least. I mean, I went into Apple because I made certain — came to certain conclusions about both the intelligence with which the capital would be employed, but more important, about the value of an ecosystem and how permanent that ecosystem could be, and what the threats were to it, and a whole bunch of things. And that didn't — I don't think that required me to, you know, take apart an iPhone or something and figure out what all the components were or anything. It's much more the nature of consumer behavior. And some things strike me as having a lot more permanence than others.

But the answer is, we'll miss a lot of things that — or I'll miss a lot of things — that I don't feel I understand well enough. And there is no penalty in investing if you don't swing at a ball that's in the strike zone, as long as you swing at something at some point, then you know, eventually that you find the pitches you like. And that's the way we'll continue to do it. We'll try to stay within our circle of competence. And Charlie and I generally agree on sort of where that circle ends, and what kind of situations where we might have some kind of an edge in our reasoning or our experience or something that — where we might evaluate something differently than other people. But the answer is, we're going to miss a lot of things.

CHARLIE MUNGER: Yeah, we have a wonderful system. If one of us is stupid in some area, so is the other. (Laughter) And of course, we were not ideally located to be high-tech wizards. How many people of our age quickly mastered Google? I've been to Google headquarters. They look to me like they're — it looks like a kindergarten. (Laughter)

WARREN BUFFETT: No, it's extraordinarily impressive, what they've done. And like I say, at GEICO we were paying them a lot of money at the time they went public. And all three of the main characters — Eric [Schmidt] and Larry [Page] and Sergey [Brin] — they actually came and saw me. But they were more interested in talking about going public and the mechanics of it and various things along that line. But it wasn't like what they were doing was a mystery to me. The mystery was how much competition would come along, and how effective they would be, and whether it would be a game where four or five people were slugging it out without making as much money as they could if one company dominated.

Those are tough decisions to make. You can have industries where there's only two people in it, and they still don't (inaudible) very good because they beat each other's brains out. And that's one of the questions in the airline business. It's a better business now than it used to be, but it used to be suicide, so — (Laughs) And you know that the competitive factors are extraordinary in airlines, and how much better business is it with four people operating at 85 percent capacity than it was at — with seven or eight operating in the mid-70s, and with more planes run. Those are tough decisions. But I made the wrong decision on Google. And Amazon, I just — I really consider that a miracle, that you could be doing Amazon web services and changing retail at the same time, with — you know, without enormous amounts of capital, and with the speed and effectiveness of what Amazon has done.

I just — I underestimated — I had a very, very, very high opinion of Jeff's ability when I first met him. And I underestimated him.

2019

Brands

But you're quite correct that Amazon itself has become a brand. Kirkland, at Costco, is a $39 billion brand. All of Krae Heinz is $26 billion. And it's been around for — on the Heinz side — it's been around for 150 years. And it's been advertised — billions and billions and billions of dollars, in terms of their products. And they go through tens of thousands of outlets. And here's somebody like Costco, establishes a brand called Kirkland. And it's doing 39 billion, more than virtually any food company. And that brand moves from product to product, which is terrific, if a brand travels. I mean, Coca Cola moves it from Coke to Cherry Coke and Coke Zero and so on. But to have a brand that can really move — and Kirkland does more business than Coca Cola does. And Kirkland operates through 775 or so stores. They call them warehouses at Costco. And Coca Cola is through millions of distribution outlets.

So, brands — the retailer and the brands have always struggled as to who gets the upper hand in moving a product to the consumers. And there's no question, in my mind, that the position of the retailer, relative to the brands, which varies enormously around the world. In different countries, you've had 35 percent, even, maybe 40 percent, be private-label brands in soe drinks. And it's never goRen anywhere close to that in the United States. So, it varies a lot. But basically, retailers — certain retailers — the retail system — has gained some power. And particularly in the case of Amazon and Walmart and their reaction to it, and Costco — and Aldi and some others I can name — has gained in power relative to brands.

Krae Heinz is still doing very well, operationally. But we paid too much. If we paid 50 billion, you know, it would've been a different business. It'd still be earning the same amount. You can turn any investment into a bad deal by paying too much. What you can't do is turn any investment into a good deal by paying liRle, which is sort of how I started out in this world. Now, Krae Heinz, the profits of that business, 6 billion — we'll say very, very, very roughly, I'm not making forecasts — but 6 billion pretax on 7 billion of tangible assets, is a wonderful business. But you can pay too much for a wonderful business.

18. Internet competition for Berkshire's furniture retailers

WARREN BUFFETT: I think furnishings — the jury's still out on that, whether the operations which have grown very rapidly in size but still are incurring losses, how they will do over time. It is true that in the present market, partly because of some successes, like, most dramatically, Amazon, in the past, that investors are willing to look at losses as long as sales are increasing, and hope that there will be better days ahead. We do a quite significant percentage of our sales online in the furniture operation. That might surprise you. We do the highest percentage in Omaha.

And what's interesting is that we — I won't give you the exact numbers, but it's large — we do a significant dollar volume, but a very significant portion of that volume, people come to the store to pick up, so that they will order something from us online, but they don't seem to mind at all — and they don't have to do it — but they get a pick up at the store. So, you know, you learn what customers like, just like people learned in fast food, you know, that people would buy a lot of food by going through a drive-in, that they don't want to stop and go into the place. We learn about customer behavior as it unfolds. But I think, you know, they have a reasonable chance. Some things people — we're learning that people will buy some things that they've always gone to the mall or to a retail outlet to buy, that they will do it online. And others don't work so well. Charlie?

19. Pension funds should avoid "alternative" investments

WARREN BUFFETT: Yeah, if you leveraged up investments in just common stocks, and you'd figured a way so that you would have staying power, if there were any market dip, I mean, you'd obviously retain extraordinary returns. I pointed out, in my investing lifetime, you know, if an index fund would do 11 percent, well, imagine how well you would've done if you'd leveraged that up 50 percent whatever the prevailing rates were over time. So, a leveraged investment in a business is going to beat an unleveraged investment in a good business a good bit of the time. But as you point out, the covenants to protect debtholders have really deteriorated in the business. And of course, you've been in an upmarket for businesses. And you've got a period of low interest rates. So, it's been a very good time for it.

tiy personal opinion is, if you take unleveraged returns against unleveraged common stocks, I do not think what is being purchased today and marketed today would work well. But if you can borrow money, if you can buy assets that will yield 7 or 8 percent, you can borrow enough money at 4 percent or 5 percent, and you don't have any covenants to meet, you're going to have some bankruptcies. But you're going to also have better results in many cases. It's not something that interests us at all. We are not going to leverage up Berkshire. If we'd leveraged up Berkshire, we'd have made a whole lot more money, obviously, over the years. But both Charlie and I, probably, have seen some more high-IQ people — really extraordinarily high-IQ people — destroyed by leverage. We saw Long-Term Capital Management, where we had people who could do in their sleep math that we couldn't do, at least I couldn't do, you know, working full time at it during the day and, I mean, really, really smart people working with their own money and with years and years of experience of what they were doing.

And you know, it all turned to pumpkins and mice in 1998. And actually, it was a source of national concern, just a few hundred people. And then we saw some of those same people, aeer that happened to them once, go on and do the same thing again. If you have a choice in Wall Street between being a great analyst or being a great salesperson, salesperson is the way to make it. If you can raise $10 billion in a fund, and you get a 1 1/2 percent fee, and you lock people up for ten years, you know, you and your children and your grandchildren will never have to do a thing, if you are the dumbest investor in the world. And you know, I've told the story of asking the guy one time, in the past, "How in the world can you — why in the world can you ask for 2-and-20 when you really haven't got any kind of evidence that you are going to do beRer with the money than you do in an index fund?" And he said, "Well, that's because I can't get 3-and-30," you know. (Laughter)

CHARLIE MUNGER: What I don't like about a lot of the pension fund investments is I think they like it because they don't have to mark it down as much as it should be in the middle of the panics. I think that's a silly reason to buy something. Because you're given leniency in marking it down.

WARREN BUFFETT: Yeah. And when you commit the money — in the case of private equity oeen — you — they don't take the money, but you pay a fee on the money that you've committed. And of course, you really have to have that money to come up with at any time. And of course, it makes their return look better, if you sit there for a long time in Treasury bills, which you have to hold, because they can call you up and demand the money, and they don't count that. They count it in terms of getting a fee on it. But they don't count it in terms of what the so-called internal rate of return is. It's not as good as it looks.

20. Amazon buy doesn't mean portfolio managers aren't "value" investors

WARREN BUFFETT: Yeah. It's interesting that the term "value investing" came up. Because I can assure you that both managers who — and one of them bought some Amazon stock in the last quarter, which will get reported in another week or ten days — he is a value investor. The idea that value is somehow connected to book value or low price/earnings ratios or anything — as Charlie has said, all investing is value investing. I mean, you're puUng out some money now to get more later on. And you're making a calculation as to the probabilities of geUng that money and when you'll get it and what interest rates will be in between. And all the same calculation goes into it, whether you're buying some bank at 70 percent of book value, or you're buying Amazon at some very high multiple of reported earnings.

Amazon — the people making the decision on Amazon are absolutely as much value investors as I was when I was looking around for all these things selling below working capital, years ago. So, that has not changed. But they are looking for things that they feel they understand what will be developed by that business between now and Judgement Day, in cash. And it's not — current sales can make some difference. Current profit margins can make some difference. Tangible assets, excess cash, excess debt, all of those things go into making a calculation as to whether they should buy A versus B versus C. And it really, despite a lot of equations you learn in business school, the basic equation is that of Aesop. And your success in investing depends on how well you were able to figure out how certain that bush is, how far away it is, and what the worst case is, instead of two birds being there, and only one being there, and the possibilities of four or five or ten or 20 being there.

CHARLIE MUNGER: And we're not the most flexible, probably, in the whole world. And of course, if something as extreme as this internet development happens, and you don't catch it, why, other people are going to blow by you. And I don't mind not having caught Amazon early. The guy is kind of a miracle worker. It's very peculiar. I give myself a pass on that. But I feel like a horse's ass for not identifying Google better. I think Warren feels the same way.

WARREN BUFFETT: He's saying we blew it. (Laughter) And we did have some insights into that, because we were using them at GEICO, and we were seeing the results produced. And we saw that we were paying $10 a click, or whatever it might've been, for something that had a marginal cost to them of exactly zero. And we saw it was working for us. So —

CHARLIE MUNGER: We could see in our own operations how well that Google advertising was working. And we just sat there sucking our thumbs. (Laughter) So, we're ashamed. We're trying to atone. (Laughter) Maybe Apple was atonement.

Reinsurance

WARREN BUFFETT: Well, our insurance business gives us a float that's other people's money, which we're temporarily holding, but which gets regenerated all the Mme, so as a practical matter, it has a very, very long life. And it's probably a liRle more likely to grow than shrink. So, we have $124 billion that people have given us. And that's somewhat like having a bank that just consists of one guy. And people come in and deposit $124 billion and promise not to withdraw it forever. And we've got a very good insurance business. It's taken a very long Mme to develop it, very long Mme. In fact, I think we probably have the best property-casualty operation, all things considered, in the world, that I know of, of any size. So, it's worth a lot of money.

It's probably — we think it's worth more to us, and we parMcularly think it's worth more while lodged inside Berkshire. We'd have a very, very high value on that. I don't want to give you an exact number, because I don't know the exact number. And any number I would have given you in the past would've turned out to be wrong, on the low side. We have managed to earn money on money that was given to us for nothing and have (inaudible) earnings from underwriMng and then have these large earnings from invesMng. And it's an integral part of Berkshire.

There's a certain irony to insurance that most people don't think about. But if you really are prepared, and you have a diversified property-casualty insurance business — a lot of property business in it — if you're really prepared to pay your claims under any circumstances that come along in the next hundred years, you have to have so much capital in the business that it's not a very good business. And if you really think about a worst-case situaMon, the reinsurance — that's insurance you buy from other people, as an insurance company, to protect you against the extreme losses, among other things — that reinsurance probably — could likely be — not good at all.

So, even though you'd think you're laying off part of the risk, if you really take the worst-case examples, you may well not be laying off the risk. And if you keep the capital required to protect against that worstcase example, you'll have so much capital in the business that it isn't worthwhile. Berkshire is really the ideal form for wriMng the business. Because we have this massive amount of assets that, in many cases, are largely uncorrelated with natural disasters. And we can — we don't need to buy reinsurance from anybody else. And we can use the money in a more efficient way than most insurance companies.

It's interesMng. The three — In the last 30 years, the three largest reinsurance companies — and I'm counMng Lloyd's as one company — although it isn't — it's a group of brokers assembled in — underwriters assembled at a given locaMon. But people think of Lloyd's as a massive reinsurance market, which it is, not technically one enMty. But if you take the three largest companies — and they're all in fine shape now, they're first-class operaMons — but all three of them came close to exMncMon someMme in the last 30 years, or reasonably close.

And we didn't really have any truly extraordinary natural catastrophes. The worst we had was Katrina in, whatever it was, 2006 or thereabouts, 2005. But we didn't have any worst-case situaMon. And all three of those companies, which everybody looks at as totally good on the asset side, if you show a recoverable from them, two of the three actually made some deals with us to help them in some way. And they're all in fine shape now.

But it's really not a good business if you keep your — as a standalone insurer — if you keep enough capital to really be sure you can pay anything that comes along, under any kind of condiMons. And Berkshire can do that. And it can use the money in ways that it likes to use. So, it's a very valuable asset. I don't want to give you a figure on it. But we would not sell it. We certainly wouldn't want to sell it for its float value. And that float is shown on the balance sheet as a liability. So, it's extraordinary. And it's taken a long Mme to build. It'd be very, very, very hard for anybody to — I don't think they could build anything like it. It just takes so long.

And we conMnue to plow new ground. If you went in the next room, you would've seen something called "THREE," which is our movement toward small and medium business owners for commercial insurance. And there's an online operaMon. And it will take all kind — we'll do all kinds of mid-course adjusMng and that sort of thing — and we've only just started up in four states.

22. "Don't go overboard on delayed gratification"

WARREN BUFFETT: It's interesting. If you think about — we'll take it to a broader point. But if you think of a 30-year government bond paying 3 percent, and you allow for, as an individual, paying some taxes on the 3 percent you'll receive, and you'll have the Federal Reserve Board saying that their objective is to have 2 percent inflation, you'll really see that delayed gratification, if you own a long government bond, is that, you know, you get to go to Disneyland and ride the same number of rides 30 years from now that you would if you did it now.

The low interest rates, for people who invest in fixed-dollar investments, really mean that you really aren't going to eat steak later on if you eat hamburgers now, which is what I used to preach to my wife and children and anybody else that would listen, many years ago. (Laughs) So, it's — I don't necessarily think that, for all families, in all circumstances, that saving money is necessarily the best thing to do in life. I mean, you know, if you really tell your kids they can —whatever it may be — they never go to the movies, or we'll never go to Disneyland or something of the sort, because if I save this money, 30 years from now, you know, well, we'll be able to stay a week instead of two days. I think there's a lot to be said for doing things that bring you and your family enjoyment, rather than trying to save every dime.

So, I — delayed gratification is not necessarily an unqualified course of action under all circumstances. I always believed in spending two or three cents out of every dollar I earn and saving the rest. (Laughter) But I've always had everything I wanted. I mean, one thing you should understand, if you aren't happy having $50,000 or a hundred-thousand dollars, you're not going to be happy if you have 50 million or a hundred million. I mean, a certain amount of money does make you feel — and those around you — feel better, just in terms of being more secure, in some cases. But loads and loads of money — I probably know as many rich people as just about anybody. And I do not — I don't think they're happier because they get super rich. I think they are happier when they don't have to worry about money. But you don't see a correlation between happiness and money, beyond a certain place. So, don't go overboard on delayed gratification.

5. Tech investing: "We won't go into something because somebody else tells us it's a good thing to do"

AUDIENCE MEMBER: Mr. Buffett and Mr. Munger, hi. My name is Daphne. I'm from New York and I'm nine years old. And I'm excited to be at the Berkshire meeting, and this is my third year.

You have often said that investors are well-served by identifying businesses with a wide moat, where the castle behind the moat is run by a king or queen who can be trusted to make good decisions. In the past, you have applied this advice by investing in businesses with world class strong brands, such as Coke, American Express, and See's, as well as media companies that has helped these brands protect and widen their moats, such as Cap Cities, ABC, and the Washington Post.

In the past, you have also generally avoided investing in technology companies, pointing out how quickly technology changes and how hard it is to build a circle of competence in it. Today, we seem to be in a world where some of the most dominant companies in the world are technology companies. And we have built powerful platforms, such as Amazon, Google, Facebook, and Microsoft in America, and Alibaba and Tencent in China. These companies all have wide moats, strong brands, and are led by brilliant — entrepreneurs.

AUDIENCE MEMBER: My question to you is this: if Berkshire is to honor its tradition of investing in wide moats and strong brands, and especially in companies that are also capital efficient, do you think that Berkshire needs to expand its investing lens to include more of these leading technology platforms? In other words, do you believe that you need to adapt your model of wide moats and strong brands to embrace, not avoid, technology? (Applause)

CHARLIE MUNGER: I think the answer is maybe. (Laughter)

WARREN BUFFETT: I think the answer is to put her on the board and it'll bring down the average age enormously. We won't get criticized as much. You're exactly right, in that we do like moats, and we used to be able to identify them in a newspaper that was the only newspaper in town, or in TV stations where we felt the dominant position, we felt the product was underpriced in terms of advertising. We saw it in brands, sometimes. And it is true that in the tech world, if you can build a moat, it can be incredibly valuable. I've not felt the confidence that I was the best one to judge that in many cases.

It wasn't hard to figure out who was winning at any given time or what their business was about, but there were a huge number of people that knew more about the game than I did. And we don't want to try and win at a game we don't understand. We may hire people, such as Ted (Weschler) and Todd (Combs), that are better at understanding certain areas of investing than I am, or maybe even Charlie is. But the principles haven't changed. You're right that some of the old ones have lost their moat and you're right that there are going to be companies in the future that have them that will be enormously valuable. And we hope we can identify one every now and then. But we won't — we'll still stay within where we think we know what we're doing. And obviously, we'll make mistakes even within that area.

But we won't go into something because somebody else tells us it's a good thing to do. I mean, we are not going to subcontract your money to somebody else's judgment. You can take your money and follow somebody else's judgment, but we're not in the business of thinking that if we hire ten people with specialties in this area or that, that it will lead to superior investment results. And we do worry that we could blow a lot of money that way.

So, we'll do our best to enlarge the circle of competence of the people at Berkshire so that we don't miss so many. But we'll miss a lot in the future. We missed a lot in the past. The main thing to do is to find things where our batting average is going to be high. And if we miss the biggest ones, that really doesn't bother us, as long as the things we do with money work out OK. Charlie?

CHARLIE MUNGER: Well, I think we've still got an awful lot of companies with big moats, and a lot of them are very — and some are industrial brands that are just incredibly strong in the niches we're in.

So, Berkshire shareholders don't need to worry about we're just one big morass of unprofitability or anything like that. But we have not covered ourselves with glory in the new fields.

8. Try to have a big circle of competence but be realistic about its perimeter

AUDIENCE MEMBER: Mr. Buffett and Mr. Munger, thank you for taking my question. My name is Feroz Qayyum and I'm from Mississauga in Canada, and now live in New York. My question is how to best emulate your success in building your circle of competence. Given the environment today in investing is a lot more competitive than when you started out, what would you do differently, if anything at all, when building your circle? Would you still build a very broad, generalist framework? Or would you build a much deeper but narrower focus, say on industries, markets, or even a country? And if so, which ones would interest you? Thank you.

WARREN BUFFETT: Yeah, well, you're right. It's much more competitive now than when I started. And you would — when I started, I literally could take the Moody's industrial manual and the Moody's banks and financial manual and I could go through page by page, at least run my eyes over every company and think about which ones I might think more about.

It's — it's important — I would just do a whole lot of reading. I'd try and learn as much as I could about as many businesses, and I would try to figure out which ones I really had some important knowledge and understanding that was probably different than, overwhelmingly, most of my competitors. And I would also try and figure out which ones I didn't understand, and I would focus on having as big a circle as I could have, and also focus on being as realistic as I could about where the perimeters of my circle of competence were. I knew when I met (GEICO executive) Lorimer Davidson in January of 1951, I could get insurance. I mean, what he said made so much sense to me in the three or four hours I spent with him on that Saturday. So, I dug into it and I could understand it. My mind worked well in that respect.

I didn't think I could understand retailing. All I'd done is work for the same grocery store that Charlie had, and neither one of us learned that much about retailing, except it was harder work than we liked.

And you've got to do the same thing, and you've got way more competition now. But if you get to know even about a relatively small area more than the other people do, and you don't feel the compulsion to act too often, you just wait till the odds are strongly in your favor. It's still a very interesting game. It's harder than it used to be. Charlie?

CHARLIE MUNGER: Well, I think the great strategy, for the great mass of humanity, is to specialize. Nobody wants to go to a doctor that half-proctologist and half-dentist, you know? (Laughter)

And so, the ordinary way to succeed is to narrowly specialize. Warren and I really didn't do that. And that — and we didn't because we prefer the other type of activity. But I don't think we could recommend it to other people.

WARREN BUFFETT: Yeah, a little more treasure hunting in our day, and it was easy to spot the treasures —

CHARLIE MUNGER: We made it work, but it was kind of a lucky thing.

CHARLIE MUNGER: It's not the standard way to go.

WARREN BUFFETT: The business, at least I best understood, actually was insurance. I mean — and I had very little competition. You know, I went to the insurance department in Harrisburg, Pennsylvania. I remember one time I drove there just to check on some Pennsylvania company. And this is when you couldn't get all this information on the internet. And I went in and I asked about some company, and the guy said, "You're the first one that's ever asked about that company." And there wasn't a lot.

I went over to the Standard and Poor's library on Houston — Houston — Street, I guess they call it. And I would go up there and ask for all this obscure information. And there wasn't anybody sitting around there. They had a whole bunch of tables that you could set and examine things through. So, there was less competition. But if you know even one thing very well, it'll give you an edge at some point. You know, it's what Tom Watson Sr. said at IBM, you know. "I'm no genius, but I'm smart in spots and I stay around those spots." And that's basically what Charlie and I try and do. And I think that's probably what you can do. But you'll find those spots in —

CHARLIE MUNGER: Yeah, we did it in several fields. That's hard.

WARREN BUFFETT: And we got our head handed to us a few times, too.

12. Why Berkshire doesn't put its unspent cash into a stock index fund

But I would argue that if you were working with smaller numbers, it would make a lot of sense. And if you're working with large numbers, it might well make sense in the future at Berkshire to operate that way.

So, we've been — we're operating on the basis that we will get chances to deploy capital. They will come in clumps in all likelihood. And they will come when other people don't want to allocate capital. I don't think — certainly, you know, in the next 20 or 30 years there'll be two or three times when it'll be raining gold and all you have to do is go outside. But we don't know when they will happen. And we have a lot of money to commit. And I would say that if you told me I had to either carry short-term Treasury bills or have index funds and just let that money be invested in America generally, I would take the index funds. But we still have hopes. And the one thing you should very definitely understand about Berkshire is that we run the business in a way that we think is consistent with serving shareholders who have virtually all of their net worth in Berkshire. I happen to be in that position myself, but I would do it that way under any circumstances.

14. "Ingenious" capitalism will replace jobs lost to automation

AUDIENCE MEMBER: Hi. Hi Warren, hi Charlie. My name is Carrie and this is my daughter, Chloe. She's 11 weeks. It's her very first Berkshire meeting. (Laughter) We're from San Francisco, and we have a question on employment for you. As both a major employer and a producer of consumer goods, what do you make of the uncertain outlook for good full-time jobs with the rise of automation and temporary employment?

WARREN BUFFETT: Well, if we'd asked that question 200 years ago, and somebody said, "With the outlook for development of farm machinery and tractors and combines and so on —" meaning that 90 percent of the people on farms were going to be — lose their job — it would look terrible, wouldn't it? But our economy and our people, our system, has been remarkably ingenious in achieving whatever we have now — 160 million jobs — when throughout the period ever since 1776, we've been figuring out ways to get rid of jobs. That's what capitalism does, and it produces more and more goods per person. And we never know exactly where they're going to come from. I mean, it — I don't know if you were whatever occupation — well, if you were in the passenger train business, I mean, you know, you were going to — that was going to change.

But we find ways, in this economy, to employ more and more people. And we've got now more people employed than ever in the history of the country, even though company after company in heavy industry and that sort of thing, has been trying to figure out, naturally, how to get more productive all the time, which means turning out the same number of goods with fewer people, or turning out more goods with the same number.

That is capitalism. I don't think you need to worry about American ingenuity running out. I mean, if you look at people in all kind of businesses, and they like to make money, but they really like to be inventive, you know. They like to do things. And this economy, it works. It will continue to work. And it will be very — it's very tough in certain industries, and there will be dislocations. You know, we won't be making as many horseshoes and that sort of thing when cars come along and all that.

But we do find ways now to employ whatever we're employing — 155, whatever it is — million people, and supporting a population of 330 million people when we started with 4 million people, with 80 percent of the labor being employed on farms. So, the system works and it will continue to work. And I don't know what the next big thing will be. I do know there will be a next big thing. Charlie?

CHARLIE MUNGER: Well, we want to shift the scut work to the robots to the extent we can. That's what we were doing, as Warren said, for 200 years. Nobody wants to go back to being a blacksmith, or scooping along the street, picking up the horse manure, or whatever the hell people used to do. We're glad to have that work eliminated.

And a lot of this worry about the future comes from leftists who worry terribly that the people at the bottom of the economic pyramid have had a little stretch when the people at the top got ahead faster. That happened by accident because we were in so much trouble that we had to flood the world with money and drive interest rates down to zero. And, of course, that drove asset prices up and helped the rich. Nobody did that because they suddenly loved the rich, it was just an accident, and it will soon pass. We want to have all this productivity improvement, and we shouldn't worry a little about the fact that one class or another is a little ahead at one stretch.

24. Power of American Express's brand will help fend off heavy credit card competition

BECKY QUICK: This question comes from Leiders Luff (PH), Yosis Luff (PH), and Dan Gorfung (PH) of Israel. And they write to both Mr. Buffett and Mr. Munger, "Do you think that AmEx's share of mind is enough to win the credit cards race? How do you see AmEx's competitive position now compared to the past? And who is the most threatening competitor now, compared to the past?

WARREN BUFFETT: Yeah, everybody's a competitor, including now Apple. It has just instituted a card, I guess, in conjunction with Goldman Sachs. Everybody — there will always be, in my view, many, many competitors in the business. Banks can't afford to leave the field. It's a growing field. They build up receivables on it. But I wouldn't think of the credit card business as a one-model business any more than I would think of the car business as essentially being one model. I mean, Ferrari is going to make a lot of money, but they're going to have just a portion of the market. Well, AmEx is growing around the world with individuals, it's growing around the world with small businesses. You just saw the contract they made with Delta — which is probably the ideal partner— that runs, what, for eight or nine, whatever it may be, nine or 10 years, actually.

You know, the billings go up per capita, they go up — the coverage spreads. And they're going to have loads of competition, and they always will. But they had — you know, that's something — J.P. Morgan, you know, took on the Platinum Card. It was a competitor, and the Platinum Card had the highest renewal rates that they've had. And they increased the price I think from 450 to $550 during a competitive battle, and retention improved, and new business improved, and 68 percent or so of the new business was millennials.

I mean, it is a — it is not an identical product with anything else. And as a premium card, it has a clientele which is large. It may only be — it may be X percent of the market, it may be three-quarters of X percent, or whatever it may be. It isn't for the person that likes to have five cards and look every day at which one provides the most rewards that day or in what gas stations or something of the sort.

But it's got a very large constituency that has a renewal rate, a usage rate, that's the envy of everybody else in the industry. So, I like our American Express position very well.

CHARLIE MUNGER: As you say, we own the world if it doesn't change. No, I'm talking about WeChat.

31. Expand you circle of competence if you can, but don't force it

AUDIENCE MEMBER: Hi, Warren. Hi, Charlie. My name is Jacob (PH). I'm a shareholder from China and also a proud graduate of Columbia Business School. Thanks for having us here. (Cheers) My question is, our world is changing at a faster pace today versus 40 years ago and even more so going forward. And in this context, for each of us individually, should we expand our circle of competence continuously over time? Or should we stick with the existing circle but risk having a shrinking investment universe? Thank you.

WARREN BUFFETT: Well, obviously you should, under any conditions, you should expand your circle of competence if you can. And I've expanded mine a little bit over time. But — Yeah. You can't force it. You know.

That doesn't mean you can't expand it at all. I mean, I did learn about some things as I've gone along in a few businesses. In some cases, I've learned that I'm incompetent, which is actually a plus, then you've discarded that one. But it doesn't really — the world is going to change. And it's going to keep changing. It's changing every day. And that makes it interesting. You know. And as it changes, certainly within what you think is your present existing circle, you have to — you should be the master of figuring that one out or it really isn't your circle of competence. And if you get a chance to expand it somewhat as you go along —

I've learned some about the energy business from Walter (Scott) and Greg (Abel) as we've worked together, but I'm not close to their level of competence on it. But I do know more than I used to know. And so, you get a chance to expand it a bit. Usually, I would think normally your core competence is probably something that sort of fits the way the mind has worked. Some people have what I call a "money mind." And they will work well in certain types of money situations.

It isn't so much a question of IQ. The mind is a very strange thing. And people have specialties, whether in chess or bridge. I see it in different people that can do impossible — what seem to me — impossible things. And they're really kind of, as Charlie would say, stupid in other areas — (laughs) — you know.

32. It's easy to make 50% on a million, but much more difficult on larger amounts

Mr. Buffett, you've said that you could return 50 percent per annum, if you were managing a one-million-dollar portfolio. What type of strategy would you use? Would you invest in cigar butts, i.e., average businesses at very cheap prices? Or would it be some type of arbitrage strategy? Thank you.

WARREN BUFFETT: It might well be the arbitrage strategy, but in a very different, perhaps, way than customary arbitrages, a lot of it. One way or another, I can assure you, if Charlie was working with a million, or I was working with a million, we would find a way to make that with essentially no risk, not using a lot of leverage or anything of the sort. But you change the one million to a hundred million and that 50 goes down like a rock. There are little fringe inefficiencies that people don't spot. And you do get opportunities occasionally to do. But they don't really have any applicability to Berkshire. Charlie?