This past weekend I made the pilgrimage to Omaha to hear Warren Buffett and Charlie Munger conduct the Berkshire Hathaway annual meeting and dispense never-ending wisdom. The following are the first part of my notes from the meeting. I hope you will appreciate their insights as much as I did.

First-Quarter Earnings--Last night Berkshire reported first-quarter earnings. Overall results were impacted by about $1.6 billion of mark-to-market losses on Berkshire's derivatives contracts, which are primarily some credit default swaps as well as some put options on the value of a basket of equity indexes. This mark-to-market should be largely ignored, as Berkshire intends to hold these contracts to maturity, even though accounting rules require the change in their value to run through the income statement.

As expected, Berkshire's biggest business, insurance, had lower results due to softening rates across most business lines. The most marked decline at Berkshire Hathaway Reinsurance, where catastrophe insurance policies have been declining (and Berkshire has prudently pulled back from some of these markets). Auto-insurer GEICO still produced decent growth, despite slowing rates.

On the investing side, Berkshire completed the deal for Marmon Group for $4.5 billion and purchased over $10.5 billion in fixed-income securities. This is significant, as Buffett, while typically recognized for his great stock picks, is just as good if not a better fixed-income investor. Given the dislocation in the credit markets over the last quarter, Berkshire was able to pick up bonds with very compelling yields. Taken together, Berkshire's cash balance was down to about $31 billion as of March 31. This doesn't include the $6.5 billion that Berkshire agreed to pay to finance Mars' purchase of Wrigley in April. Since Berkshire must hold around $10 billion of cash for insurance regulatory purposes, its disposable cash balance is down to about $15 billion--a level much lower than in years past, and potentially indicative of Buffett finding attractive investments amid the market dislocations of the past year.

Hopes for Berkshire--Buffett said he hopes Berkshires culture stays strong and remains a home for businesses that were built by families over time. He also hopes that the company will continue on as it is now by being a home for great businesses. I'll note that culture is one of the most valuable parts of any business, but the most difficult to quantify. In Berkshire's case, Buffett views sharpening the Berkshire culture as his chief objective, and in my view this culture will give his successor(s) an advantage in continuing to build the company for decades to come.

Pharmaceutical Stocks-- Buffett thinks pharma stocks as a group will do well, but given that it is very difficult to value what is in the pipelines of these companies, he thinks investors would be best served by buying a basket of pharma stocks.

Envy vs. Gluttony-- Buffett said that envy is the worst of the sins because if you become envious you feel worse, while the other person is the same--or even feels better. He said, tongue-in-cheek, that gluttony on the other hand has upside.

Dividends for Berkshire? A shareholder asked Buffett about the potential for dividends at Berkshire, and he said that as long as he can continue to create more than $1 of value with every $1 of retained earnings, Berkshire will not pay dividends. Given that Buffett has been putting a lot of capital to work lately with the Marmon Group, Mars/Wrigley, additional equity investments, and, more recently, new fixed-income investments, there is tremendous potential for Berkshire to still create wealth by retaining all of its earnings.

Credit Default Swap Market--A shareholder asked Buffett about the potential for a blowup in the credit default swap market, and Buffett said he thinks that a meltdown of these instruments is unlikely. He thinks that the chances of this have been dramatically reduced by the Fed stepping in on the Bear Stearns situation (which I think implies that he thinks this sets a precedent for the financial markets). He further said that the gains on one end of the swap market would be offset by losses on the other end, and that it is more of a transfer of money than a systemic risk to markets as a whole. In illustrating his point, Buffett referred to another insurance firm, Fairfax Financial, which benefited from the re-pricing of credit default swap risks. In many ways, Fairfax has roughly modeled its business structure on Berkshire.

Munger on Financial Innovation--Munger said that if regulators had banned the phrase, "this is a financial innovation that diversifies risk," the financial markets would have been a lot better off.

Munger on Greenspan--"Alan Greenspan's embrace of the free markets did overdose a little bit on Ayn Rand."

Fair Value Accounting-- Buffett said he thinks the use of fair value accounting may serve to discourage management teams from doing overly risky loans going forward. He went on to say that some esoteric securities are so difficult to understand that he wouldn't know where to begin to value them.

The Credit Crisis-- Buffett said that in his career he can't remember one episode where a blowup in residential real estate has sent shock waves throughout the financial world. He went on to say that he didn't think many of these weak lending practices will happen anytime again in the near future. Munger said Web-van, which in his words was an asinine idea, was more intelligent than what happened in the mortgage market over the last few years.

Munger's Reading List-- Munger recommended reading Cialdini's book *Influence*, in addition to his new book *Yes!*

Your Most Important Investment-- Buffett said the most important investment you can make is in yourself, because an individual's potential often exceeds realization. He further said he asks high school students that if they could buy one car for their entire life, how would they treat it? He then drew an analogy to caring for an individual's mind and body. Buffett said the reason people are effective in life is because other people want to be around them and work with them.

Outlook on Coal-- Buffett said that in the short term the world is in need of more coal, but that longer term it would be critical to find alternative sources of energy, and that in Berkshire's Mid-American utility business, they have been investing in wind power, among other alternatives. Munger said that from a resource-allocation perspective, he would rather have the world use up all its coal first, before using its supplies of hydro-carbons.

The Use of Models-- Buffett indicated that in an investment professional, you need somebody who can be trusted and who has reasonable analytical skills, but more importantly, someone who can imagine risks that haven't ever happened, which most models don't capture. He said he used this approach in his search for a new Chief Investment Officer, which he stated in his 2006 annual report. He also noted that his thoughts were somewhat prophetic given what has happened in the credit markets over the last few months, where most of the large financial institutions' quantitative models didn't accurately capture the potential for what eventually happened. I think this is insightful, as it's always important to remember that models are tools in the analytical process, and not outcomes.

The Mars/Wrigley Deal--Buffett remarked that he was contacted to help in the financing of Mars' announced acquisition of Wrigley last week. He indicated that the Mars family only wanted to deal with him, because they knew the cash would be there, and they appreciated that Berkshire didn't require layers of management approval and bureaucracy to get the deal done. I've thought for some time that these elements give Berkshire an advantage vis-a-vis many other private equity firms competing for business acquisitions. I further think these competitive advantages will give Berkshire's new CEO a leg up when that person eventually takes the reins.

The Complexity of Financial Institutions--Buffett received a question about the complexity of financial institutions and if they have become too difficult to manage. In a word, Buffett said yes, but that despite this, most of the organizations will work fine most of the time. And as for Berkshire, Buffett remarked that he thinks of himself as the firm's chief risk officer, which gives me comfort that he is probably thinking of risks to the company that most people haven't even fathomed yet.

Munger on Ethanol--Munger said that the policy of turning American corn into automobile fuel is an incredibly stupid idea.

Buffett on Oil--Buffett said he thinks the surplus capacity in producing oil is smaller than he can ever remember. He added that when oil ever hits its maximum production levels, it will hit a gradual decline in supply, though he said he doesn't have any idea of when we will hit our peak. He said that there are no short-term fixes to weaning the world off of oil, but that eventually behavior will adjust or alternatives will develop. Buffett said that it's hard for him to imagine that demand will starting falling off based on current circumstances. Munger referred to solar as an alternative source of energy and said we have no other real alternative than the sun.

Munger on Diversification--"The whole secret of investment is to find places where it's safe and wise *not* to diversify."

Succession Planning--A shareholder asked Buffett to give an update on his succession plan. He reiterated his previous thoughts and said that he has three potential candidates to take over the CEO job, and has four potential candidates to take over the investment responsibilities. It is the Berkshire board's decision to decide who those individuals will ultimately be. He also said that the new CEO would likely have some input on who the investment officer(s) would eventually be.

Munger on Making Investments--"We buy businesses that are drowning in cash."

Buffett on the Dollar--A shareholder asked Buffett about his view on the dollar. He said he thinks that the U.S. is going to continue to pursue policies that will cause the dollar to fall vis-a-vis other currencies. He further said that he doesn't hedge Berkshire's dollar exposure, but is happy to own either businesses or marketable securities that have foreign earnings power. This is consistent with what Buffett has said over the last year: Instead of taking a direct currency position, he would rather own a business with foreign earnings power. However, this is but only one of the criteria that he uses when considering potential investments.

Municipal Bond Insurance-- Buffett indicated that in the first quarter of 2008, Berkshire's new municipal bond insurer, Berkshire Hathaway Assurance, did premium volume of over $400 million, primarily written in the secondary market--meaning Berkshire sold insurance on bonds that were already insured by other muni insurers. Effectively, Berkshire is doubly insulated on these contracts, as not only would the municipality have to go into default (which has historically been a very low probability event) but the pre-existing bond insurers would also have to fail to pay their claims. Given this double layer of protection on these already relatively safe bonds, these transactions seem to me like almost free money for Berkshire.

Munger on Exploiting Market Dislocations--"If you can't think fast and act resolutely, it does you no good."

Pair Trading--A shareholder asked Buffett if he did pair trading (going long one security and short a similar security) in his partnerships in the 1960s. Buffett said that he was roughly doing a version of that in the 1960s, but that he's made more money by going long than pair trading. Munger added, "We made our money by being long some wonderful businesses."

Buffett on Communication--"The ability to communicate both in writing and orally is enormously important and under taught."

Career Advice--A shareholder asked Buffett if he would do it all over again, what would he do, and why? Buffett said yes of course, and that he loves what he does and he loves his life. For the rest of us, he said, "It would be a terrible mistake to sleepwalk through your life." He then indicated that it's important to do something that you have a passion for and that gets you excited to get out of bed in the morning, which is how he felt when he worked for his mentor Ben Graham in New York.

Common Stock and Berkshire Returns--A shareholder asked Buffett for his outlook on Berkshire's future equity and overall returns. Buffett said he thinks Berkshire would be lucky to earn 10% on its stock investments over time. He also said he thinks Berkshire's returns will be lower than they have been. Both of these expectations are primarily due to Berkshire's large size and that it needs "elephants" to move the needle on the valuation. He further said that he thinks Berkshire stacks up well compared with other large corporations, but that the rate at which Berkshire will make money in the future will almost assuredly be lower than in the past. He did say, though, that with smaller amounts of money, some investors could do better than Berkshire because the smaller asset size opens up a much greater universe of opportunities than is currently available to Berkshire. He did go on to indicate that it will take a lot of time and work to potentially uncover mis-priced securities. These overall viewpoints are consistent with what he has said in prior meetings, and also during his search for a new investment officer(s).

Philanthropic Advice from Munger--Here is a paraphrase of his comments: If you are politically far to the right or far to the left, you'll probably make a lot of dumb charitable gifts.

Use of Options--A shareholder asked Buffett about his use of stock options in his equity positions. He said that he doesn't use options around his equity positions and that if an investor likes the business and wants to buy a stock, he should just buy the stock and forget about the options on the stock. Buffett then said that the chief difficulty of using options is that they require an element of timing that is very difficult to predict. Buffett went on to say that in business schools, students just need to take two courses that will help them become better investors. One is a course on how to value a business, and the other is a course on how to think about market fluctuations. The key insight here is that investing comes down to a basic understanding of business fundamentals and having an emotional stability that allows one to have a mind set that is different from the market or the crowd.

Investment Advice--A shareholder asked how one can correct their mind set away from a crowd mentality. Buffett said to read and re-read Ben Graham's *The Intelligent Investor*. He specifically said that chapters 8 and 20 are most poignant, but that the lessons from the book are as relevant today as they were when he first read Graham's book when he was 19 years old. He also said there are basically three lessons to take away from the book: (1) Think of stocks as owning parts of a business, (2) Use the market to serve you rather than instruct you, and (3) Always require a margin of safety when investing. In today's environment, these principles are critical, and I especially think the second one is important to remember, as, in my opinion, it can help investors tune out the rampant noise in the market, helping them improve their investment temperament over time.

After I get a chance to review and refine more of my notes we'll have a second part to the Berkshire annual meeting and Buffett and Munger's comments. As always, call with questions.

Dave