Berkshire Hathaway Annual Meeting Recap Part II

The following is the second part of my notes from our trip to the Berkshire Hathaway annual meeting:

How do Buffett and Munger control their emotions? Buffett replied: "It comes from having an investment philosophy grounded in the idea that a stock is a piece of a business. If you look at it that way, *there's no reason to get excited whether some analyst is recommending it or the company is splitting the shares two-for-one, or whatever*. The only way to drive the extraneous thoughts out of your mind is to have a philosophy. And for us that philosophy comes from Benjamin Graham and *The Intelligent Investor*, especially chapters 8 and 20. It's not very complicated stuff."

"You have to have the right temperament. I tell the students who come visit me that if you have more than 120 or 130 I.Q. points, you can afford to give the rest away. You don't need extraordinary intelligence to succeed as an investor. You need a philosophy and the ability to think independently...It doesn't make any difference what other people think of a stock. What matters is whether you know enough to evaluate the business."

"You should be able to write down on a yellow sheet of paper, 'I'm buying General Motors at $22, and GM has [566] million shares for a total market value of $13 billion, and GM is worth a lot more than $13 billion because _______________." And if you can't finish that sentence, then you don't buy the stock. [Note: Buffett mentioned GM for illustrative purposes only.] All this requires some temperamental detachment from other people's behavior. Both Charlie and I have a natural instinct in that direction. We value our opinions more than others' -- perhaps to an extreme!"

Do you mind being viewed as a bastion of calm by others? Buffett simply stated, "I think they're probably right," while Munger said: "Not only are they right, but it's a huge advantage to us to get the reputation of being wiser and stronger than other places. Would any of you object to being considered wiser and stronger when you're trying to get anything in life? *The key is not to be seduced by crazy ideas*, *but instead just stick to the fundamentals year after year*. Academia doesn't get too interested in us--we're too simple. What would the professors do? A great many of the formulas they use to analyze securities and markets are dead wrong. They exist purely to give the intellectual class something to do. We don't do anything just to exercise our intellectual proclivity for mathematical formulas."

Buffett added: "*There's no reason we should become fearful if a stock goes down. If a stock goes down 50%, I'd look forward to it. In fact, I would offer you a significant sum of money if you could give me the opportunity for all of my stocks to go down 50% over the next month*."

That is powerful. What Buffett is actually saying is that most people's emotions work backwards: *They get greedy when stock prices go up and fearful when they go down*. Instead, if you are a true investor (as opposed to speculator), you should shop for stocks the same way you shop for anything else: Look for sale prices, and never regard falling prices as inherently bad news. Instead, falling prices create the opportunity to buy even more of something that was already worth owning.

In that single sentence Buffett captured the difference between investing and speculating: An investor, like Buffett, wants the price of a stock to fall below the value of its underlying business so he can buy even more and hold for as long as possible. A speculator (like Jim Cramer) only wants the price of a stock to go up, with no regard for the value of the underlying business at all, so he can sell as fast as possible. To the investor, the market's opinions do not matter. To the speculator, they are the only thing that matters.

Do you think the U.S. financial markets are losing their competitive edge? And what's the right balance between confidence-inspiring standards and between regulation and the Wild West? Well, I don't think we're losing our edge. There are costs to Sarbanes-Oxley, some of which are wasted. But they're not huge relative to the $20 trillion in total market value. *We've got fabulous capital markets in this country, and they get screwed up often enough to make them even more fabulous*. *You don't want a capital market that functions perfectly if you're in my business. People continue to do foolish things no matter what the regulation is, and they always will*. There are significant limits to what regulation can accomplish. As a dramatic illustration, take two of the biggest accounting disasters in the past ten years: Freddie Mac and Fannie Mae. We're talking billions and billions of dollars of misstatements at both places.

Now, these are two incredibly important institutions. I mean, they accounted for over 40% of the mortgage flow a few years back. Right now I think they're up to 70%. They're quasi-governmental in nature. So the government set up an organization called OFHEO. I'm not sure what all the letters stand for. But if you go to OFHEO's website, you'll find that its purpose was to just watch over these two companies. OFHEO had 200 employees. Their job was simply to look at two companies and say, "Are these guys behaving like they're supposed to?" And of course what happened were two of the greatest accounting misstatements in history while these 200 people had their jobs. It's incredible.

It's very, very, very hard to regulate people. If I were appointed a new regulator - if you gave me 100 of the smartest people you can imagine to work for me, and every day I got the positions from the biggest institutions, all their derivative positions, all their stock positions and currency positions, I wouldn't be able to tell you how they were doing. It's very, very hard to regulate when you get into very complex instruments where you've got hundreds of counterparties. The counterparty behavior and risk was a big part of why the Treasury and the Fed felt that they had to move in over a weekend at Bear Stearns. And I think they were right to do it, incidentally. Nobody knew what would be unleashed when you had thousands of counterparties with contracts with a $14 trillion notional value. Those people would have tried to unwind all those contracts if there had been a bankruptcy. What that would have done to the markets, what that would have done to other counterparties in turn - it gets very, very complicated. So regulating is an important part of the system. The efficacy of it is really tough.

I know you had a paper route. Was that your first job? Well, I worked for my grandfather, which was really tough, in the family grocery store. But if you gave me the choice of being CEO of General Electric or IBM or General Motors, you name it, or delivering papers, I would deliver papers. I would. I enjoyed doing that. I can think about what I want to think. I don't have to do anything I don't want to do. It might be wonderful to be head of GE, and Jeff Immelt is a friend of mine. And he's a great guy. But think of all the things he has to do whether he wants to do them or not.

How do you get your ideas? I just read. I read all day. I mean, we put $500 million in PetroChina. All I did was read the annual report.

How does the current turmoil stack up against past crises? Well, that's hard to say. Every one has so many variables in it. But there's no question that this time there's extreme leveraging and in some cases the extreme prices of residential housing or buyouts. You've got $20 trillion of residential real estate and you've got $11 trillion of mortgages, and a lot of that does not have a problem, but a lot of it does. In 2006 you had $330 billion of cash taken out in mortgage refinancings in the United States. That's a hell of a lot - I mean, we talk about having $150 billion of stimulus now, but that was $330 billion of stimulus. And that's just from prime mortgages. That's not from subprime mortgages. So leveraging up was one hell of a stimulus for the economy.

If that was one hell of a stimulus, do you think the $150 billion government stimulus plan will make an impact? Well, it's $150 billion more than we'd have otherwise. But it's not like we haven't had stimulus. And then the simultaneous, more or less, LBO boom, which was called private equity this time. The abuses keep coming back - and the terms got terrible. You've got a banking system that's hung up with lots of that. You've got a mortgage industry that's deleveraging, and it's going to be painful.

The scenario you're describing suggests we're a long way from turning a corner. I think so. It seems *everybody says it'll be short and shallow, but it looks like it's just the opposite. De-leveraging by its nature takes a lot of time, a lot of pain*. And the consequences kind of roll through in different ways. Now, I don't invest a dime based on macro forecasts, so I don't think people should sell stocks because of that. I also don't think they should buy stocks because of that.

Your OFHEO example implies you're not too optimistic about regulation. Finance has gotten so complex, with so much interdependency. I argued with Alan Greenspan some about this. He would say that you've spread risk throughout the world by all these instruments, and now you didn't have it all concentrated in your banks. But what you've done is you've interconnected the solvency of institutions to a degree that probably nobody anticipated. And it's very hard to evaluate. If Bear Stearns had not had a derivatives book, my guess is the Fed wouldn't have had to do what it did.

Do you find it striking that some banks keep looking into their investments and not knowing what they have? I read a few prospectuses for residential-mortgage-backed securities - mortgages, thousands of mortgages backing them, and then those all tranched (packaged) into maybe 30 slices. You create a CDO by taking one of the lower tranches of that one and 50 others like it. Now if you're going to understand that CDO, you've got 50-times-300 pages to read, it's 15,000. If you take one of the lower tranches of the CDO and take 50 of those and create a CDO squared, you're now up to 750,000 pages to read to understand one security. I mean, it can't be done. When you start buying tranches of other instruments, nobody knows what the hell they're doing. It's ridiculous. And of course, you took a lower tranche of a mortgage-backed security and did 100 of those and thought you were diversifying risk. Hell, they're all subject to the same thing. I mean, it may be a little different whether they're in California or Nebraska, but the idea that this is uncorrelated risk and therefore you can take the CDO and call the top 50% of it super-senior - it isn't super-senior or anything. It's a bunch of juniors all put together. And the juniors all correlate.

What should we say to investors now? The answer is you don't want investors to think that what they read today is important in terms of their investment strategy. *Their investment strategy should factor in that (a) if you knew what was going to happen in the economy, you still wouldn't necessarily know what was going to happen in the stock market. And (b) they can't pick stocks that are better than average. Stocks are a good thing to own over time*. There's only two things you can do wrong: You can buy the wrong ones, and you can buy or sell them at the wrong time. And the truth is you never need to sell them, basically. But they could buy a cross section of American industry, and if a cross section of American industry doesn't work, certainly trying to pick the little beauties here and there isn't going to work either. Then they just have to worry about getting greedy. You know, I always say you should get greedy when others are fearful and fearful when others are greedy. But that's too much to expect. Of course, you shouldn't get greedy when others get greedy and fearful when others get fearful. At a minimum, try to stay away from that.

By your rule, now seems like a good time to be greedy. People are pretty fearful. You're right. They are going in that direction. That's why stocks are cheaper. Stocks are a better buy today than they were a year ago. Or three years ago.

But you're still bullish about the U.S. for the long term? *The American economy is going to do fine. But it won't do fine every year and every week and every month*. If you don't believe that, forget about buying stocks anyway. But it stands to reason. We get more productive every year, you know. It's a positive-sum game, long term. And the only way an investor can get killed is by high fees or by trying to outsmart the market.

When you purchase a subsidiary, you've mentioned that you allow them to reinvest capital if they're able to go above a certain hurdle rate. I was wondering how you decide what the cost of capital should be on a risk-adjusted basis. We don't think about cost of capital or risk-adjusted. I mean, we don't want to take any risk, and we don't. That doesn't mean we don't do things that are wrong and all that, but we are not doing anything that risks real losses.

What we do with capital is we just look for the best thing we can do at any given time. We don't want to do anything that doesn't create more than a dollar's worth of value for every dollar expended. And we'll do the best we can. I may make a mistake.

If it's going to permanently lose money, I reserve the right to sell it, and if it has labor problems, I reserve the right to sell it. That's in the back of the annual report every year. They've been there for 20-plus years, those principles. But we believe in them. We follow through on them. So we won't dump a business that way. But about $200 million a week comes in to me every week. I like it, too. And it's my job to figure out how to allocate that.

The smaller capital expenditures, or even fairly large ones at the subsidiaries, they just do them themselves. They don't need me, because if some guy comes in to me and talks about something in the yarn plant or something in Georgia, what the hell do I know about it? They can always present it in a way that makes it look good. If I say the internal rate of return we demand is 15.83, it'll be 15.84. I mean, you just can bet on it. I've never seen a project that doesn't meet your hurdle rate, you know, if they really want to do it. We don't go through those charades. And it saves my time, saves their time.

If we get into bigger deals, then I get involved. Buying businesses of any size and things of that sort. But we just look for the most intelligent thing. And our cutoff point is where we don't think we're creating more than a dollar of value for every dollar we lay out. Marketable securities, to some extent we just look for the things we think have the best expectancy, but we're not buying - there isn't one security that I've got in the portfolio that I look at as-in terms of risky - in the sense of permanent capital loss. They can go down 50%.

Berkshire Hathaway itself has gone down 50% three times since I bought the first stock in at 7 3/8. In 1974 it got cut in half. In 1987 it got cut in half. In 1998, 2000 or so it got cut in half. So ***that doesn't make any difference***. I mean, I just don't worry about it. I worry about permanent loss of capital. I worry about making the right businesses. I worry about keeping the managers happy. Everything else pretty much takes care of itself.

As usual, in a world of chaos and controversy, Buffett continues to spin his wisdom in such a clear and straightforward manner. No matter what the idiots on TV or other media outlets are screaming about, Berkshire Hathaway, Buffett and Munger continue to go about their business of evaluating businesses and making investments for the long term—the really long term.

I hope my notes have been beneficial and hope that you will call to further discuss this or anything else.

Sincerely,

Dave

Dave Sather, President
CERTIFIED FINANCIAL PLANNER™